# Executive Summary

# Introduction

Securitization is an important tool in the dispersion of risk and its reallocation within the financial system. A securitized transaction involves the issue of bonds whose redemption is backed by the predetermined cash flow expected from a defined asset or group of assets.

A securitized transaction involves the following stages: An originator identifies a group of assets it wishes to securitize. The originator creates a Special Purpose Entity (SPE)[1] (or uses an existing one), which is a separate legal and economic entity. In this way, the new entity will not be exposed to the originator's risk of default. The originator transfers the defined group of assets to the SPE, which in turn issues a security to investors that is backed by the cash flow from the assets. The funds received from the issue are transferred to the originator. In many securitization transactions, the originator also serves as the servicer in order to ensure the cash flow generated by the securitized assets.[2] The use of an SPE is meant to facilitate an investment in which the risk is focused on the backed-up assets only, without the risk inherent in an investment in the originator.

A market for securitization can contribute significantly to the efficiency of the financial system and the ability to transfer risks within it. Securitization transactions increase the ability of financial entities and of firms to raise capital and provide a type of investment that is backed up by high-quality collateral. The development of a securitization market in Israel on the basis of a proper incentive structure, appropriate regulation and an infrastructure that provides legal certainty to all the sides in a transaction will increase the ability to manage risk, both for issuers and for investors. In addition, securitization is likely to assist in resolving the failure of the capital market in Israel in recent years—which was due to excess demand by investors in the corporate bond market for an investment channel considered conservative—through the increasing of investment alternatives.

Although there are risks implicit in the securitization market, which may be realized in the case of insufficient supervision, bubbles have not developed in the securitization markets of countries with appropriate regulation. In those countries, severe failures were not seen, and their markets continued to function even during the crisis. Leading international financial organizations have analyzed the causes for the crisis and have proposed changes in the regulation of the securitization markets, but at the same time

[1] Also referred to as a Special Purpose Vehicle (SPV) or a Special Purpose Company (SPC).

[2] For further details, see the Report of the Committee to Examine Aspects of Issuing Asset-Backed Bonds (Securitization), June 2005 (herein the Haimovitch-Asher Committee), Section 2.

they have stressed that this market is necessary and constitutes a channel for credit that is essential to the economy.[3]

The securitization market in Israel is in its infancy. There exist barriers to carrying out securitization transactions in Israel that result from the lack of appropriate legal, taxation, regulatory and accounting infrastructure. While in many countries, the size of the securitization market is similar to that of the corporate bond market, in Israel the market is almost nonexistent and its value is only a few billion shekels. In an international comparison of the size of the securitization market that appeared in the 2012 report of the World Economic Forum, Israel was ranked 54th among 59 rated countries.[4]

In order to develop the securitization market in Israel, a joint team (herein: the team) was established, which studied the lessons to be learned from the crisis. Its recommendations took into account potential failures in the securitization market.

The main goals of securitization transactions are to achieve optimal dispersion of risk in the financial markets, as described below, and to provide additional sources of financing. The securitization of asset-backed securities (ABS), such as repayments of commercial loans, debts from credit card transactions, municipal taxes, leasing and other future cash flows, is important to the development of the capital market in Israel.

In Europe and the US, securitization of loans to small and medium-sized businesses (SMEs) exists. Securitization of this type enables the freeing up of sources for new business loans and in this way constitutes one of the means of improving the accessibility of credit for small and medium-sized businesses. The process of issuing a loan and the collection of its payments is a complicated one and requires resources and experience. In Israel, the banks control the vast majority of the credit market for small and medium-sized businesses and they are experienced in providing them with loans and collecting payments. Therefore, there is an advantage to a system that leaves the management of loans in the hands of the banks but allows capital market investors to share part of the risk. Such a mechanism will benefit the financial system as a whole. The banks free up capital for providing new loans while continuing to manage them, while at the same time, pension savers will benefit from the possibilities of new medium- and long-term investment channels that suit their risk profile.

The measures proposed by the team and the changes proposed in the law apply to every securitization transaction, since a mechanism for selling cash flows through an SPE, the classification of a transaction as an actual sale and taxation and accounting elements are

[3] Among the organizations that have studied the securitization market are the IMF, the Federal Reserve, the G20, the Financial Stability Board, the Senate Advisory Committee and others. According to their findings, the regulation of the securitization market should be strengthened. Most of the recommendations relate to increasing transparency, modifying the incentive structure, changing the accounting standards and determining minimum standards for the quality of the assets.

[4] The full report can be found at the World Economic Forum site: http://www3.weforum.org/docs/WEF_FinancialDevelopmentReport_2012.pdf

common to all types of securitization. Therefore, the infrastructure will be designed so as to encourage a wide variety of securitization transactions in Israel.

It is important to emphasize that the securitization process involves a moral hazard problem, when the creator of risk does not bear the consequences of that risk but does profit from it. This situation creates an incentive to take risks that exceed their expected profit. As will be described below, the team took several steps with the goal of reducing the moral hazard that is implicit in securitization transactions and bringing about the correct valuation of the risk implicit in a transaction, as described in the conclusions of the various committees that were created following the last financial crisis.

The goal of the team is to encourage and develop the securitization market in Israel and to resolve issues that until now have constituted barriers to its development. This document will present, as mentioned, the ways to deal with these barriers and will also present the considerations and economic-financial analysis that served as the basis for the team's conclusions and recommendations regarding the encouragement of securitization transactions in Israel.

Throughout the process, the team has tried to maintain a correct balance between the interests of the originator, its customers, the issuing company and the investing public, while also maintaining financial stability. The recommendations of the team and the proposed legislative amendments take into account the recommendations of international organizations and their modification to the structure of the market in Israel and its conditions. Furthermore, the team decided that securitization should be introduced in stages in Israel, while adopting a policy of maximum caution.

What follows briefly describes the various factors examined by the team in arriving at its conclusions:

## Legal Aspects

Currently, Israel lacks an appropriate legal infrastructure for executing securitization transactions. The lack of such a legal infrastructure constitutes one of the major barriers to the creation of a securitization market in Israel. In addition, legal barriers were discovered that make securitization transactions excessively complex and expensive. In order to facilitate securitization transactions in Israel and ensure that they benefit from maximal legal certainty, and in order to simplify the securitization process, the team dealt with four main legal issues, and its recommendations are incorporated in the proposed legislation that is attached to this report as Appendix E:

1. **Classification of a transaction as a true sale or as a collateralized loan:**
   Since the transaction sometimes has the characteristics of a credit transaction (risk remains with the transferring company, residual rights, management of collection, etc.), there exists uncertainty as to whether the transaction should be classified as a true sale or as a collateralized credit transaction. How a transaction

is classified has legal implications on the rights of each side in the process. Thus, if the transaction is classified as collateralized credit there is the concern that future payments to the holders of the security will not be transferred in an orderly fashion in the event that the originator defaults. Therefore, the classification of a securitization transaction as a true sale is important in determining whether the transaction is worthwhile and this has implications on the interest rate to be demanded and on the rating of the bonds. In addition, it will have implications for the risk borne by the banks and therefore on the amount of capital available for credit needs.

In order to create sufficient certainty, it is proposed that the law explicitly specify that a transaction which meets certain conditions will be classified as a true sale and not as a loan. It is proposed that in order for a transaction to be considered a true sale, it should be part of the public record through its registration with the relevant authority. This public record will allow the other creditors of the originators to correctly weigh their strategy in transactions with them and thus to protect themselves. In addition, the transaction should have the characteristics of a transfer of ownership in order to be considered a sales transaction.

2. **Assigning rights to future flows that do not yet exist:**
   In some cases, the assets that back up securitization transactions are rights that do not yet exist. For example, a certain proportion of credit card transactions can be securitized by a credit card company each year. The transactions have not yet occurred, and therefore the originator does not yet have rights to them. The uncertainty as to the question of whether it is possible, according to existing Israeli law, to assign rights based on future flows that do not yet exist can place in doubt the validity of a transaction that securitizes the aforementioned rights.

   Therefore, it is proposed that the law specify that it is possible to assign rights to future cash flows for the purpose of securitization transactions, on the condition that both the assigner and the assignee are corporations. It is proposed that the acquisition of the right be created only on the creation of the right and until that time there exists only obligatory rights. Nonetheless, with regard to competition for rights with a third party, the rights will be viewed as being assigned to the SPE from the time they are registered.

3. **Registration of accompanying collateral: Ensuring simplicity in the process of transferring collateral from the bank to the SPE (the special case of mortgage securitization)**
   Apart from the case of a transfer of future payments, a securitization transaction can involve the transfer to the SPE of the lien on the underlying assets, which was provided as collateral to guarantee future payments. In mortgage securitization transactions, the encumbered real estate is the collateral provided to guarantee the underlying assets. In order to carry out a securitization

transaction under the proposed law, a transfer is required of the lien on the real estate from the originator to the SPE and therefore the transfer should be registered in the Land Registry. It is proposed that that registration of collateral be kept simple by requiring only one transfer deed for each Registry district. It should be mentioned that other significant exemptions in the registration of collateral that guarantees such assignments have already been instituted as part of the Economic Arrangements Law (amendments to achieve the budget and policy targets for the fiscal year 2002–03)[5] (herein: the Arrangements Law), as long as it is supervised entities that are involved.

4. **Collection and exercise management**

In a securitization transaction, the rights of the originator are assigned to a different entity (the SPE). The assigned rights are derived from the rights of the originator based on contracts between it and its customers (herein: the underlying transaction). In cases where the originator is a supervised entity, the protection provided to the customers with respect to the way in which the debt is managed may be diminished.

In view of the aforementioned, it is proposed that if the underlying transaction (such as a loan in a bank mortgage transaction) is carried out with a supervised entity, i.e., a banking corporation or institutional investor, its management will remain with the originator, as long as this is required to ensure the collection of payments. However, if the originator is a supervised entity and the SPE is as well, the management can be placed in the hands of the SPE. Nonetheless, it is proposed that such management be made possible only if directives on this matter have been issued by the Supervisor of Banks or the Commissioner of the

[5] Paragraph 45 specified as follows:

45. Regardless of what is stated in any other law, the receiving corporation is not permitted to carry out any action for the management of collateralized loans, to collect payments on the loan or to realize the collateral, except in the following circumstances:

1) Regarding a receiving corporation that is not a bank nor an insurer:
   a. By means of a banking corporation: when the transferring corporation which receives the collateral first (in this paragraph, the transferor) is a banking corporation;
   b. By means of an insurer: when the transferring corporation is an insurer;
2) Regarding a receiving corporation that is a bank:
   a. Itself or by means of a different banking corporation: when the transferring corporation is a banking corporation or when the transferring corporation is an insurer and the Supervisor, as defined in the Supervision of Insurance Businesses Law, 5741-1981, has given his approval;
   b. By means of an insurer: when the transferring corporation is an insurer;
3) Regarding a receiving corporation that is an insurer:
   a. Itself or by means of a different insurer: when the transferring corporation is an insurer or when the transferring corporation is a banking corporation and the Supervisor, as defined in the Banking (Licensing) Law, 5741-1981, has given his approval;
   b. By means of a banking corporation: when the transferring corporation is a banking corporation.

Capital Markets, Insurance and Savings, according to the circumstances, and according to those directives.

It is proposed that the Minister of Justice be given the authority to decide on additional cases in which the SPE will not be permitted to carry out any action to manage the underlying transaction except through a corporation of the type to be specified by the Minister.

## Aspects Related to the Demand for Securitization Transactions

### (1) Issuing to the public

Offerings to the public will be carried out according to a prospectus whose publication has been approved by the Israel Securities Authority (ISA). The legislative framework proposed by the team includes a proposal by the ISA to amend the Securities Law, 5728-1968.

The proposed amendment to the Securities Law complements the Ministry of Justice's proposed legislation, as will be described below. According to what is proposed, only securitization transactions that meet the conditions set out in the Ministry of Justice's proposed legislation and which will therefore benefit from legal certainty regarding the classification of the transaction as a true sale and in addition fulfill the instructions contained in the ISA's proposal can serve as a basis for offering of securities to the public according to a prospectus that has been approved for publication by the ISA.[6]

Among the instructions within the proposed amendment to the Securities Law:

- Instructions regarding the signing of a prospectus and a draft prospectus.
- Instructions specifying that the credit risk remain with the originator (which requires the originator to continue to hold 10 percent of the securitized portfolio, with the goal of reducing the moral hazard implicit in these transaction and to ensure that the originator continues to have an interest in the securitized portfolio).
- Instructions that limit the activity of the SPE and the relationship between the originator and the SPE, with the goal of ensuring that the sole goal of the SPE is to serve as a conduit and to thus reduce the risk to which the bond investors are exposed.
- Instructions regarding the self-purchase of asset-backed bonds.
- Instructions regarding chain securitization.

In addition to the aforementioned, securitization transactions require disclosure with special characteristics and in this context it is proposed that the recommendations of the Haimovitch-Asher Committee be adopted and that when there is legal and economic

[6] These rules will apply to the securitization activities of banking corporations with modifications that will be specified by the Supervisor of Banks.

separation between the underlying assets and the other assets of originators or assets under their management, the SPE's prospectus will primarily include the information that is relevant to describe the SPE, the underlying assets and a description of the transaction, and there is no need for a full description of the originator's other assets or activities.

The principles of disclosure will be specified in the regulations and will include the scope of required disclosure in the prospectus and in immediate reports, with the goal of creating the desired transparency for investors.

**(2) Issuing to institutional investors**

An issue to institutional investors is one that is only offered to institutional investors (which are listed in the First Addendum to the Securities Law) and not to the general public. The securities in such issues are not sold to the general public and therefore the SPE is not subject to the supervision of the ISA. In the case of an issue to institutional investors, the SPE must meet conditions that will be determined by the Supervisor of the Capital Market.

## Aspects of Supervision, Restrictions and Instructions that Will Apply to the Originator in a Securitization Transaction

**(1) Banks that serve as originators**

When the originator is a bank or a corporation controlled by a bank, including the case when the financial statements of the SPE are consolidated with those of the bank, the supervision of the originator, the servicer and the SPE will be the responsibility of the Supervisor of Banks.

In order to encourage securitization transactions in Israel and to ensure that they are executed in an optimal manner, the Banking Supervision Department has drafted guidelines that will apply to securitization. The guidelines have undergone several changes and in general are intended to achieve the following goals: establishment of clear and transparent principles (a kind of "express lane" for securitization activity), shortening of the discussion processes with specific banks and the widening of certain parameters in order to encourage the start of activity.

The Banking Supervision Department’s guidelines that relate to securitization activity are made up of three complementary layers:

a. **Creation of a general framework and basic principles**: Within this framework, principles will be established for reducing the moral hazard implicit in securitization transactions to a minimum and in addition to ensure that the securitization transaction does not endanger the stability of the bank. Among the instructions:

- A provision requiring the bank to hold at least 10 percent of the securitized portfolio, with the goal of preserving its economic interest in the portfolio and preventing moral hazard in the process of providing the loans.
- A provision prohibiting the bank from "cherry picking" when choosing the loans for a securitization portfolio, with the goal of preventing a situation in which the securitization of assets diminishes the quality of the loan portfolio remaining with the bank.
- A provision prohibiting the bank from providing liquidity assistance to an SPE if it is in distress, with the goal of ensuring the stability of the bank and avoiding a situation in which the bank is in distress as a result of its liquidity assistance to the SPE.

b. **Accounting treatment:** The regulations of the Supervisor of Banks for reporting to the public adopt the relevant regulations in the US (166, 167).[7] These regulations were instituted as a result of the lessons learned from the global financial crisis. The regulations have led to significant changes in the accounting treatment of the transfer of financial assets and in particular have redefined the conditions for a bank to be able to remove from its balance sheet financial assets that it has securitized.

c. **Capital adequacy:** Proper Conduct of Bank Business Directive 205 on "Securitization", which is included in the file "Measurement and Capital Adequacy" (adoption of the Basel II regulations),[8] relates to the issue of capital adequacy in securitization transactions. The Directive also specifies that at this stage and until the US and international rules for securitization stabilize, exemptions for the allocation of capital for securitizing housing loans will not be conditioned on the question of whether the transaction is recognized as a sale for accounting purposes.

**(2) Institutional investors that serve as originators**

When the originator is an institutional investor, supervision is the responsibility of the Commissioner of Capital Markets, Insurance and Saving. He has circulated a letter among institutional investors (see Appendix A) that describes the importance of the securitization market for the dispersion of risk in the capital market. The Capital Market Branch will examine the way in which securitization transactions are to be executed by institutional investors and will establish rules to ensure that the directives regarding the participation of institutional investors, as originators or as buyers, will be consistent, to whatever extent possible, with the directives to be instituted regarding the execution of securitization transactions with the public. The Commissioner of Capital Markets

[7] http://www.bankisrael.gov.il/deptdata/pikuah/lett_sup/200931.pdf (In Hebrew)
[8] http://www.boi.org.il/en/BankingSupervision/SupervisorsDirectives/ProperConductOfBankingBusinessRegulations/205_et.pdf

will institute rules for the purchase of a securitized portfolio. With regard to the institutional investor being an originator of a securitization transaction, the Supervisor will institute rules if and when a securitization transaction is taking form.

**(3) Responsibility of the originator in issues to the public**

Within the framework of issues to the public, the originator bears the responsibility to the SPE and the holders of asset-backed bonds for what is presented in the prospectus, which is in addition to its responsibility arising from its relations with third parties (such as holders of the bonds it has issued). This is established by its signing of the prospectus for the public offering of the asset-backed bonds.

In addition, and as mentioned above, it is proposed that a certain amount of risk remain with the originator (or originators, depending on the transaction) and they will be required to hold 10 percent, on a cumulative basis, of an asset-backed bond series that is offered to the public.

## Taxation Aspects of Securitization Transactions

There is no specific taxation arrangement in existing law for securitization transactions. As mentioned, the lack of an arrangement creates a tax distortion in these transactions, which significantly increases their cost, to the point that they are no longer worthwhile. The goal of the team in dealing with the taxation issue was to achieve neutral taxation of securitization transactions, or in other words that securitization transactions will not create any excess burden on the originator or investors on the one hand and will not provide any exemption or tax incentive on the other.

During its work, the team studied three models for solving the taxation problem arising from securitization transactions. This included an examination of the current laws regarding securitization in various countries and consultation with accounting experts and with representatives of corporations who intend to carry out securitization transactions in the future. The main problem in taxation of securitization transactions is related to the taxation of the SPE. The exclusive goal of the SPE is to serve as a conduit between the originator and the investors and it is not meant to have any commercial goals. Thus at the end of the transaction, the income of an SPE is meant to equal its expenses. At the same time, during the life of the securitization transaction, a situation may arise in which the income and expenses of the SPE are unsynchronized, such that during the initial tax years the SPE will show a profit for tax purposes while in the later tax years it will show a loss. Since according to the tax laws in Israel there is no option to carry forward tax losses, a situation will be created in which the SPE must pay tax during the initial years of its life, while during its later years it will experience a loss that

cannot be offset. Therefore, according to current tax laws, the SPE will have to pay tax even though its only goal is to serve as a conduit that does not create any profit.

According to the proposed arrangement, which is based on the parallel between the cash flows received by the SPE and the payments that it makes each tax year, the SPE's income will be tax-exempt if certain conditions are fulfilled. The goal of these conditions is to ensure that the SPE has no independent commercial character, apart from carrying out the securitization transaction, and that during the period of the securitization it will serve only as a conduit. Meeting the conditions will exempt the SPE from the payment of taxes and will ensure that the securitization transaction does not create any excess tax burden.

In addition, and in order to avoid a tax barrier created by the taxation of the transaction to assign the assets to the SPE in certain cases, it is also proposed that when the SPE is fully owned by the originator and the underlying assets have been approved by the Ministry of Finance and they do not have any cost for tax purposes, a special tax arrangement will apply. According to the special tax arrangement, the income received by the originator from the SPE as part of the securitization transaction will not be viewed as income to the originator and the income and expenses of the SPE will be attributed to the originator. This special arrangement is proposed in order to preserve the financing advantage achieved in a securitization transaction.

## Conclusion

In the view of the team, the recommendations that appear below provide an adequate solution to the regulatory problems that arise in plain vanilla securitization transactions. If these recommendations are implemented, there will no longer be any regulatory barrier to the creation of securitized assets that will be sold to the public and to institutional investors, which will contribute to the efficiency and competition of the capital market. It is hoped that securitization will make it possible for small banks and nonbank entities to raise capital against economic activity that produces relatively assured cash flows that can be sold to medium- and long-term investors. As mentioned, the team is committed to balancing between the development of the capital market and preserving the financial stability of the capital market in Israel.

## The Team's Work

This report constitutes a summary of the work of the joint team to promote securitization.[9] The creation of an infrastructure for the carrying out of securitization transactions required the study of numerous aspects of the issue and from a number of angles. Each of these aspects must be dealt with, since each is critical in determining the profitability of securitization transactions and the feasibility of developing a securitization market in Israel. The team often found that the various aspects of the issue were interconnected and that a decision regarding one had a major effect on decisions regarding the others. Thus, it is important that the work of the team took into account all these aspects simultaneously and strove to achieve synergy between them.

The work of the team was coordinated by the Bank of Israel. The team included representatives of the Israel Securities Authority, the Ministry of Justice, the Ministry of Finance and the Israel Tax Authority. The team investigated various aspects of the issue and what is being done in other countries and recommended which amendments are required in order to create an appropriate infrastructure for securitization transactions in Israel. The team worked transparently with the Capital Market Forum, in which various regulators of the capital market meet with representatives of the private sector. The team is grateful to all the partners who contributed to this report.

During its work, the team was assisted by the international firms of Freshfields and Blake Dawson, which provided legal consultation on comparable laws abroad in order to decide on the legal infrastructure for securitization transactions in Israel. The work of the team also included consultation with representatives of the private sector in order to ensure that all the elements of securitization transactions were being taken into account and in order to remove the barriers that stand in the way of those entities that wish to engage in securitization transactions. The team is grateful to all the experts that advised it during the course of its work.[10]

[9] A list of those participating in compiling this report appears in Appendix C.
[10] See the list in Appendix D.