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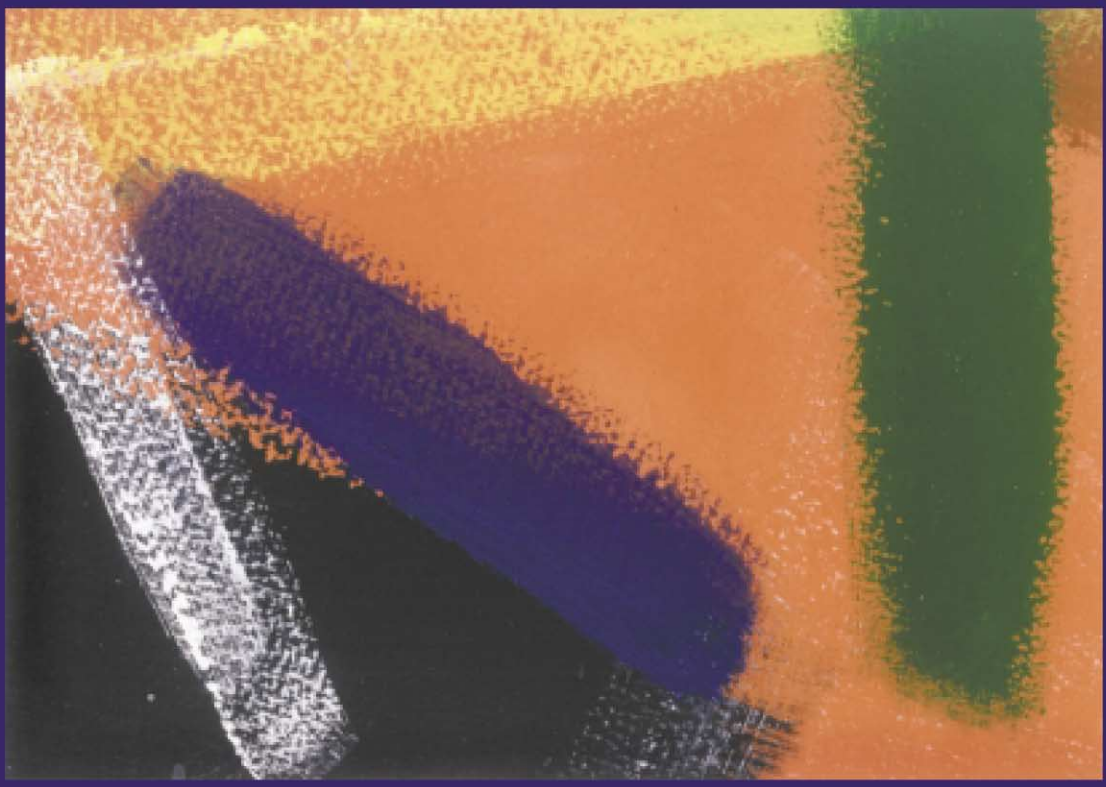
Yigal Arnon & Co



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Securitisation in Israel

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The securitisation market in Israel is still in a state of development. Providers of car leasing services have become the main business sector which, as a common practice, relies on securitisation transactions as a principal means of financing, especially for the acquisition of new vehicles. Tens of such transactions have been executed in Israel in the last five years, securitising anticipated cash flow deriving from specific car leasing contracts with specific clients. Securitisation transactions in other sectors have been more scarce and have included securitisation of residential mortgage loans, receivables deriving from the sale of flats, tenancy payments and higher education fees. Two major securitisation transactions involved public companies which sold existing and future receivables due from their customers to US financial institutions, who, in turn, financed the purchase of the receivables through the issue of securities outside of Israel.

At the same time, in recent years, securitisation transactions have been at the focus of industry's attention. As businesses strive to diversify their sources of finance, looking for terms more favourable than those offered to them by the Israeli banking system, securitisation is one of the methods often explored. Certain recent developments in the Israeli legal and financial environment, and moreover, certain anticipated reforms (as detailed below) are likely to encourage the use of securitisation transactions as a preferred method of financing in the Israeli business arena.

Typical structure of Israeli securitisation transactions

The majority of Israeli securitisation transactions have been structured in accordance with the classic structure used in many jurisdictions: an originator sells and assigns its right to receive certain future payments (underlying receivables) from third parties (referred to as the debtors) to an SPV, a company newly incorporated solely for the purpose of the securitisation transaction. Often, the assignment agreement contains the

obligation (and a right) of the originator to provide certain services to the SPV, typically collection services and various other services to the debtors, and the right of the SPV to replace the originator as service provider in certain circumstances. The SPV then issues debentures to the investors. Other players in these transactions are the trustee, who is vested with certain powers and rights in order to protect the interests of the debenture holders; and a supervisor, who monitors the Originator's compliance with its obligations under the assignment and services agreement.

In almost all of the Israeli securitisation transactions to date, the debentures were privately offered to institutional investors. We have not yet seen public offerings of SPVs on the Tel Aviv Stock Exchange. Offerings of securities to institutional investors are exempt from the Israeli Securities Law regulatory requirements, including the prospectus publication requirement. Institutional investors are defined in a schedule to the Securities Law, and include, inter-alia, pension funds, insurance companies, mutual investment funds, banks and venture capital funds.

For many institutional investors, rating by a recognised rating agency is a pre-condition for investment in debt securities. Hence, in almost all Israeli securitisation transactions, the debentures were rated by Ma'alot. Ma'alot was the sole local rating agency active in the Israeli market, until the establishment in 2003 of a second rating agency, called Midrug. The rating agency has played a very dominant role in the detailed structuring of securitisation transactions. As the rating is based on various assumptions and covenants of the originator, these covenants are reflected in the transaction documents, and the occurrence of events more adverse than those anticipated by the rating agency often constitute events of default under the debentures.

One of the requirements of the rating agency and the investors is that the value of the Underlying Receivables assigned to the SPV exceeds the sum of the debt to the investors, so that even if a portion of the Receivables is cancelled or not collected for any reason, there are still sufficient funds to service the debt. The surplus, to the extent created, typically returns to the originator, either at the final maturity of the debentures or on certain pre-determined points of times during the life of the debentures, by one of two methods:

(a) contractual obligation of the SPV to pay to the originator additional consideration if certain conditions are met; or

(b) the SPV issues a subordinated debenture to the originator and the surplus amount is considered as repayment of principal and/or interest thereon.

The legal framework

No special legislation exists in Israel to regulate securitisation transactions. The relevant legal provisions are, therefore, the general concepts that exist in the general civil legislation, contract, trust and insolvency law as well as the general accounting principles and general tax laws.

Main relevant features of the Assignment Law

The right to assign:

The Assignment Law 1969, which is the main Israeli statute dealing with the assignment of rights, sets forth the general principal that rights can be assigned by the creditor without the debtor's consent, unless the right is not transferable pursuant to any other law, by virtue of the particular nature of the right or pursuant to an agreement between the creditor and the debtor. Rights to receive payment in consideration for products sold or services rendered are considered to be transferable by their nature (except in very unique circumstances).

There are certain indications in the case law that future rights cannot be assigned before the rights are created, namely before the agreement creating the right is concluded. Therefore, in securitisation transactions which include revolving obligations of the originator to replace underlying receivables which are cancelled with new underlying receivables, or an option/obligation of the originator to sell additional underlying receivables to the SPV, appropriate measures should be taken to effect the assignment of the new underlying receivables once they are in fact created, such as execution of an assignment deed, amendment of the registration (see below), etc.

Notice to the debtor:

While an assignment is effective even without giving any notice thereof to the Debtor, notification can improve the legal position of the assignor in some ways. In the vast majority of Israeli securitisation transactions, notices were not given to the Debtors, despite the adverse legal implications, since the giving of the notice was considered impractical. The Assignment Law provides that if the debtor pays the debt to the assignor (in our case – the originator) before receipt of notice of the assignment, the assignee (in our case – the SPV) shall have no claim against the debtor, unless the debtor has acted in bad

faith. Safeguarding measures which are often taken in the absence of notification to the debtor, are: the creation of a security interest in favour of the SPV over the Originator's bank account into which the receivables are being paid by the debtors, and designation of that bank account as being held in trust in favour of the SPV. Notice to the debtor is also critical in the situation of conflicting assignments of the same right: The Assignment Law provides that if the assignor assigned the same right to two different assignees, the assignment earlier in time prevails, except if the debtor was notified of the later assignment before it was notified of the former assignment, in which case the later assignment prevails.

The true sale question – potential recharacterisation?

A key element in any securitisation transaction is the investors' endeavor to totally disassociate themselves from any risks related to the creditworthiness of the originator. This aim is achieved by the complete sale of, and the transfer of the full ownership in, the underlying receivables to the SPV. However, a potential risk remains that the securitisation transaction, although structured as a full sale, will be recharacterised as a pledge/security interest transaction.

The source of this risk is Section 2(b) of the Pledge Law – 1967 which provides: "The Pledges Law applies to any transaction, the intention of which is to create a security interest in an asset in order to secure the repayment of a debt, regardless of its formal characterisation."

The Pledge Law further provides that a security interest which is not duly perfected is not effective vis-à-vis other creditors of the pledgor, and in particular is ineffective and is not recognised by the liquidator of the pledgor. Where a security interest is created by a company, an effective perfection means, with respect to most types of assets, registering the security interest on the records of the company in the database maintained by the Israeli Registrar of Companies.

In the past, Section 2(b) of the Pledge Law was interpreted very broadly by the Israeli courts. The result was that many transactions, which were not characterised by the parties thereto as financing and pledge transactions (eg sale of goods by a supplier to a retailer with a retention of title clause pending the payment of the purchase price), were in fact recharacterised by Israeli courts as pledge transactions. In a recent case, the Israeli Supreme Court acknowledged that excessive application of the recharacterisation powers may hinder business and commercial development in the Israeli market, and suggested a much narrower interpretation of Section 2(b). Nevertheless, the exact scope of the recharacterisation risk is still far from being clear and is being determined on a case-by-case basis.

In the context of securitisation transactions, the concern is that if the originator becomes insolvent, the appointed liquidator will attempt to recharacterise the securitisation transaction, arguing that in its essence, nature and business rationale, it was a transaction by which the originator raised financing, offering certain receivables as a security for the repayment thereof. The liquidator may further argue that, in the absence of proper perfection, this security interest is ineffective, and the assigned receivables do not actually belong to the SPV, but should return to the pool of assets of the liquidated company and be available for distribution to all the originator's creditors.

In Israeli securitisation transactions, two approaches have been taken to address this potential risk:

(a) Legal opinion –legal counsel provide the SPV and the debenture holders with a true sale opinion. In such an opinion, counsel has analyzed the relevant features and characteristics of the specific transaction, identifying those features that, in counsel's opinion, are evidence of the true sale nature of the transaction and distinguish it from secured financing arrangements. In the absence of precedents in Israeli case law referring specifically to securitisation transactions, counsel giving such opinions have relied mainly on analogies from other situations in which the issue of transfer of ownership arose, and on the position taken on this question by other jurisdictions.

(b) Registration of security interest – Under this approach, although the transaction is structured, and the documentation drafted, to provide for a full assignment and sale of the receivables from the originator to the SPV, a first ranking fixed security interest over the receivables is nevertheless registered on the records of the originator with the Israeli Registrar of Companies. If, during the life of the transactions, additional receivables are assigned (eg in lieu of receivables that are cancelled or turn out to be defective), registration of a security interest over the new receivables is again effected. This approach is obviously less neat and tidy, but it

is a practical solution which gives a higher degree of comfort against a potential challenge of the effectiveness of the assignment by the originator's liquidator. The liquidator will have no motivation to recharacterise the assignment as a security interest, as even if it succeeds in this argument, the registration would make this security interest effective vis-à-vis the liquidator, ranking first in comparison to other creditors.

Main tax issues

Requests for tax pre-rulings

Israeli tax legislation does not include specific provisions regulating securitisation transactions. As a result, it is often the case that prior to the completion of a securitisation transaction, both the originator and the SPV request specific tax pre-rulings from both the Income Tax Authority and the VAT Authority, to ensure that the structure of the transaction will not lead to prohibitive tax liabilities to either the originator or the SPV. Among the main pre-rulings which are often requested are: exemption from VAT liability to the SPV; the non taxation of profits which sometime technically accrue to the SPV due to the inevitable timing gaps between the dates of collecting the receivables and the dates of payment to the debenture holders; and in transactions which are not structured as off balance-sheet transactions, a ruling providing that the assignment of the receivables will not be considered as a sale by the originator and therefore will not trigger immediate income tax obligation for the full amount received.

Withholding tax (payable upon discharging the underlying receivables)

Under Israeli income tax legislation, in the vast majority of commercial non-retail transactions, the payer is in principle subject to a duty to withhold tax at source from any payment it makes (the rate of withholding tax varies and may reach 50 per cent), unless the payee presents a valid withholding tax exemption. In practice, most payees hold general withholding tax exemptions, and tax is not often withheld by payers in commercial transactions. However, this mechanism is regarded by the tax authorities as a very important enforcement tool, as payees who do not regularly comply with their tax obligations are not granted withholding tax exemptions.

In the context of securitisation transactions, the debtor may ask itself whether a withholding tax exemption obtained by the SPV is sufficient, or an exemption of the originator is also required. If the debtors insist on the production of an exemption by the originator, this may materially prejudice the value of the receivables and the creditworthiness of the SPV, making the value of the receivables linked to and dependent on the status of the relationship between the originator and the income tax authorities.

This issue is not clear under the current tax legislation. In a recent decision of the Tel Aviv District Court, the court addressed an assignment scenario (not securitisation) and indicated that the withholding tax requirement applies vis-à-vis the assignee and there is no need for an exemption to be produced by the assignor. An appeal to the Supreme Court, filed by the income tax authorities against this decision is currently pending, and consequently uncertainty on this important issue still remains. It is therefore recommended to clarify this point, prior to the completion of the securitisation transaction, in a pre-ruling obtained from the Income Tax Authority granting a withholding tax exemption valid throughout the life of the transaction.

Exemption from stamp duty

Until January 2004, the issuance of debentures by the SPV was subject to stamp duty at the rate of 1 per cent of the amount of the debentures, and in addition some of the transaction documents were subject to stamp duty at lower rates. The stamp duty was seen as one of the major obstacles to the development of the Israeli securitisation market, as it added a substantial margin to the already high transaction costs involved. Following intensive lobbying efforts from the industry, the Israeli Government has decided to exempt all the documentation involved in securitisation transactions from stamp duty.

The future of the Israeli securitisation market

Two recent regulatory trends in the Israeli financial markets have the effect of encouraging market participants to explore new methods of financing, outside of the traditional local banking system. The first is the tightening supervision of the Bank of Israel (Israel's central bank) over Israeli banks, reflected, inter-alia, in increased restrictions on lending to a sole borrower or a group of borrowers, and increased capital adequacy requirements. This has led to a contraction of banking system credit sources available for lending in the Israeli market, thus making such credit more expensive. The second is a recent liberalisation in the investment regime to which pension funds and other institutional investors are

subject, permitting and encouraging such institutions to invest in types of investments formerly restricted or unattractive for tax reasons, thus making these institutional investors an important source for debt and equity financing in the Israeli market.

The Israeli Government and the Ministry of Finance acknowledge that diversification of the sources of finance available to businesses is an important and desired objective, and that regulatory obstacles should be removed to accomplish it. In the Government resolution pursuant to which the stamp duty exemption (discussed above) was passed, it was explained that the exemption is the first in a series of steps targeted to encourage and to facilitate the raising of financing from sources other than the banking system. In an official publication, the Ministry of Finance has stressed the importance of creating a secondary market for mortgage backed loans, and even offered to pay a financial bonus to the first bank that will securitise mortgage backed loans in the amount of at least NIS 500 million (approx. €93 million).

As part of this trend, on January 2004, the Chairman of the Israeli Securities Authority and the Income Tax Commissioner formed a joint committee, with members from both those authorities as well as from the Ministry of Justice, to examine the aspects of Israeli law that may hinder the development of securitisation transactions and public offerings of asset backed securities. The committee is currently hearing legal, accounting and tax experts and hopes to submit recommendations in the near future. It is expected that the committee will come up with two sets of recommendations:

(a) first, the committee will propose short term solutions to the most problematic obstacles currently inhibiting the development of the securitisation market and which can be implemented by rather minor amendments to the legislation;

(b) at a later stage, the committee will propose a full legislative reform package, which will set forth a comprehensive legal framework for securitisation transactions.

Among the major securitisation transactions which are currently in the process of formation in the Israeli market are:

- Securitisation of insurance brokerage fees, where the originator is an insurance broker and the receivables to be transferred to the SPV are the anticipated insurance brokerage fees due from an insurance company for policies sold by the broker.
- Sale of residential mortgage backed loans by one of the major Israeli banks;
- Municipal securitisations – legislation currently obliges municipalities to gradually transfer their water supply activities into new municipal corporations incorporated solely for that purpose. It is anticipated that these corporations will raise funds from institutional investors to finance the purchase of the assets and activities from the municipalities. Moreover, guidelines recently issued by the Ministry of Finance permit municipalities to form new single-purpose municipal corporations that will engage in distinct new projects promoting the public welfare (such as the construction of parking lots), and allow these corporations, under certain terms and conditions, to raise funds in the capital market.

Conclusion

While the Israeli securitisation market is still in a state of development, a need for, and interest in more such transactions definitely exists with both consumers and potential providers of such finance. The Israeli Government, as well as the securities and the tax authorities understand the importance of this tool, and when the reforms announced by these authorities are implemented, it is expected that securitisation transactions will become a much more widely used method of financing in the Israeli market.

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