The decoding of the new Law regarding Securitization in Cyprus: The past, the present and the future.

The Securitization market was created in the early 1970s in the United States, with the sale of the first unified mortgage loan package guaranteed by government agencies. In 1985 in the US the long-term debt Securitization market with the Issue of Asset-Backed Securities (ABS) of $ 1.2 billion. Since then, the US market has grown dramatically in 2002, bringing new ABS versions to around $350 billion. The regions of Europe and Asia have taken the lead in rapid growth.

In Cyprus on the 13/07/2018, the new Law on Securitization was voted by the Parliament. Under the new Law **2018 (88(I)/2018)**, Securitization of loans is the financial instrument that allows the transferring entity (credit institution) to proceed to a transfer through the transfer of a group loans granted to a Company-vehicle called a Special Purpose Entity for Securitization (SSPE). Securitizations undertaken in or from Cyprus are regulated by the Central Bank of Cyprus.

This Special purpose entity for securitization (SSPE) issues bonds that it directs to interested investors. The aim of this new law is "wider risk - sharing by allowing licensed credit institutions to transfer the risk of certain exposures (such as credit facilities and in particular non-performing loan facilities - NPLs) to other institutions or long-term institutional investors (e.g. asset managers).

Accordingly, Securitization of loans will allow banks to "free up capital to cover risks" from NPLs. Based on the new Law, "Securities provide new investment opportunities for long-term institutional investors (such as insurance companies and pension funds)". According to the new Law, the administrative body of the company is made up of persons who are not members of the administrative body of the credit institution with which it will cooperate. An authorization will be granted to a company based in Cyprus so that it can be supervised without interruption by the Central Bank and its statutes will not allow the issue of public limited liability companies. Any fees or taxes related to the transfer and securitization of exposures and related collateral to the SPE (Special Purpose Entity) do not affect the interested borrower and under no circumstances this transfer, and Securitization affects its borrowing costs negatively.

Benefits will also arise for the transferring entity as there will be a reduction in financing costs, a strengthening of liquidity, maintaining capital adequacy, managing the risks of credit institutions from their lending portfolios. Investors through the SPE (Special Purpose Entity) are performing higher returns, diversifying their investment portfolio, and protecting SPE (Special purpose Entity) by removing the insolvency risk of the transferring entity. Benefits will also be recorded for the economy as capital market growth, additional borrowing opportunities, a source of funding for banks and corporations is expected to emerge, and the borrowers' borrowing costs is expected to be reduced.

The securitization process in general.

The entity that originally holds the assets (the **originator**) initiates the process by selling the assets to a legal entity, an SPV or SPE (**Special Purpose Vehicle/Entity**), specially created to limit the risk of the final investor vis-à-vis the issuer of the assets. The SPV may be constituted as a limited company, a trust or other legal entity, and must be administered by either a limited company duly licensed for this purpose by the Central Bank of Cyprus, an entity duly authorized for this purposed by another relevant authority, a credit institution, a credit acquiring company or financial institution whose license permits the administration of such SPVs . An SPV is also referred to as a “conduit.” Then, depending on the situation,

Maria Hadjisavva
Associate

the SPV either issues the securities directly or resells the pool of assets to a "trust" that, in turn, issues the securities (the trust is actually used for several securitization transactions and therefore oversees several SPVs).

A SPV is more of a legal framework than an element that plays an active part in the transaction. The most important role is played by the **arranger**, typically a bank, who sets up the transaction and evaluates the pool of assets, the way in which it will be fed, the characteristics of the securities to be issued, and the potential structuring of the fund. The object of the structuring is to model the characteristics of the securities such that they correspond to the needs of the final investor. Instead of simply paying the final investor the revenue generated by the assets, the amortization rules for the security are defined in advance. Some ABSs are able to be "topped up," meaning that the pool of assets can be refed during the life of the security. This makes it possible to refinance short-term debts (such as credit-card debt) with long-term bonds. Finally, the **arranger** plays an important role in distributing the securities to the final investors (distribution). Quite often, the securities are not issued on an exchange, but are distributed over-the-counter to a small number of investors. The trio of actors comprising the "**originator, SPV, and arranger**" constitutes the "**Originate-to-Distribute**" model. An important distinction must be made between "traditional" securitization, where the assets are actually sold to the SPV ("true sale"), and what is known as "synthetic" securitization, where the originator retains ownership of the assets and transfers only the risk to the SPV, via a credit derivative. This transaction brings no liquidity to the assignor but enables him to externalize the risk associated with holding the securitized assets.

<u>The advantages of securitization in general.</u>

<u>For the seller</u>

For the originator, the main reason for securitizing is to reduce (some might say "get rid of") the amount of assigned debt from his balance sheet, which on the one hand leads to a corresponding reduction to the capital required to be kept on the orignator's/seller's books to satisfy regulatory capital requirements under Basel III, and on the other hand enables the originator to bring in additional liquidity (which can be used to make new loans).

<u>For the investor</u>

ABS (asset backed securities) present an opportunity to invest in asset classes that are not accessible in the markets and that offer a risk/return profile that is, in principle, attractive.

"ABS have become a well-established asset class within the fixed income markets, offering high credit quality and attractive risk-adjusted yields compared to other spread product. Despite some of the risks associated with ABS such as prepayment or extension risk, the significant credit enhancement and structural support inherent in most transactions make ABS a quality fixed income investment choice for the institutional portfolio." ("A primer on Asset-Backed Securities" – Dwight asset management company)
"ABS are a means of diversifying a portfolio into low-risk products that, by virtue of their structure, offer exposure to a diversified portfolio."

"Since the underlying assets are diversified, clearly identified, and pledged to the holder, the credit rating agencies claim that in the event of default (theoretically speaking), the recovery rate for the holder is very high."

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Associate

Securitization is an important source of alternative funding, especially for banks and other financial institutions, but also for businesses themselves; and constitutes an investment vehicle for institutional and retail investors.

<u>For the market</u>

In principle, securitization helps to spread out risk within the market, so that the risk is no longer concentrated solely in the hands of credit agencies and institutions.

Maria Hadjisavva
Associate