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SECURITIZATION IN EMERGING MARKETS, INCLUDING GOVERNMENT PROMOTION OF SECURITIZATION

A COMMENT ON HILL & ARNER

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The articles by Professors Doug Arner and Claire Hill address two aspects of securitization in emerging markets. Professor Arner's article, *Emerging Market Economies and Government Promotion of Securitization*, describes the benefits of securitization, provides an overview of the key underlying elements that are necessary for the development of securitization in emerging markets, and stresses the need for government leadership in the process. Professor Hill's article, *Whole Business Securitization in Emerging Markets*, focuses on the benefits and value that could result in emerging markets from pursuing a relatively new form of securitization—the securitization of whole businesses.

Emerging markets could indeed benefit from securitization. For example, many financial institutions would not have been as adversely affected by the Asian financial crisis if they had been able to spread out their risk through the use of mortgage-backed securitization. However, the establishment of securitization structures will take time. As Professor Arner argues, "traditional asset securitization structures cannot simply be 'parachuted' into individual financial systems."[1] Rather, a "complex matrix of supporting elements, all of which have a significant legal element," must be put into place for asset securitization to be successful.[2] With regard to the traditional and most common form of asset securitization, the securitization of mortgages, he rightly argues that this matrix must include the following

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1. *See* Douglas Arner, *Emerging Market Economies and Government Promotion of Securitization*, 12 DUKE J. COMP. & INT'L L. 505, 506 (2002).

2. *Id.*

elements: (1) a real estate-based finance market (the primary mortgage market); (2) capital markets (including secondary mortgage markets and domestic bond markets); and (3) infrastructure supporting securitization.[3] Professor Arner highlights the need for government involvement in developing these three elements and promoting mortgage securitization. Governments must pay particular attention to the development of the necessary economic and legal framework for supporting securitization. Furthermore, Professor Arner correctly stresses that in emerging markets, this consideration necessitates starting with the enactment and enforcement of clear real property rights, efficient mechanisms for transferring these rights (including bankruptcy and foreclosure laws), and the use of real property as collateral.[4] It cannot be overemphasized that anticipated benefits from securitization will not accrue until these basic matters are properly addressed.

Professor Arner might consider adding a fourth element into the matrix—infrastructure for cross-border securitization. Banks in many emerging countries, and in Asia in particular, would most likely have to hold a regional portfolio of investments in order to achieve the same level of diversification that U.S. banks holding a national portfolio achieve. It is difficult enough to determine how to perfect security interests in mortgage-backed securities when focusing on the laws of one country with developed securitization procedures in place; these determinations are more complicated in cross-border scenarios involving emerging markets.

Professor Hill focuses on a different aspect of securitization, the benefits that would result in emerging markets from whole business securitization.[5] In such a transaction, a group of creditors provides a company's entire debt funding through a special purpose vehicle (SPV). The creditors agree at the time the loan is made on their respective rights and obligations if the company later encounters financial problems.

In a whole business securitization, simultaneously with the SPV making the loan, the corporate borrower grants the SPV fixed and floating charges on all its corporate assets. This is a crucial part of the

3. *Id.* at 506–07.

4. *Id.* at 514.

5. *See* Claire A. Hill, *Whole Business Securitization in Emerging Markets*, 12 DUKE J. COMP. & INT'L L. 521 (2002). As she notes, whole business securitization would include "not only the firm's receivables, but also its plant, property and equipment, intellectual property, and all its other assets." *Id.*

transaction, for as Professor Hill emphasizes, the success of whole business securitization requires that the priority rights of secured creditors are absolutely respected. At present, this level of protection is possible primarily in jurisdictions that have adopted the concepts from U.K. company law of respecting the priority of fixed and floating charges in corporate insolvencies[6] and, upon default, of allowing the holder of a floating charge over all or substantially all of the debtor's assets to appoint an administrative receiver/receiver to manage the company for the holder's benefit.[7] It is therefore not surprising that Professor Hill notes that whole business securitization has been used in Malaysia and is being considered for use in both Hong Kong and Singapore.

Professor Hill argues that for a business to be a suitable candidate for whole business securitization, the following factors are desirable: fairly predictable cash flow, a stable operating history, managers who are not indispensable, careful monitoring of the company and its cash flow, and no need for regular additional financing.[8] Nevertheless, Professor Hill acknowledges that these factors are not required, and she concedes that several of the conditions were not met in the one whole business securitization in Asia to date (of 1st Silicon (Labuan) Inc., in Malaysia in June 2001).[9] Indeed, at present many companies in emerging markets, particularly in Asia, will have difficulty complying with these factors for the following reasons:

- reliable, high quality cash flows are difficult to achieve;[10]
- many companies in Asia (even many, large publicly-held companies) are family-controlled; family members are often actively involved in day-to-day management and are indis-

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6. Preferential debts (e.g., statutory amounts payable to employees) rank in priority to any charge created as a floating charge.

7. Ironically, the United Kingdom itself is in the process of cutting back the rights of secured creditors. The recent White Paper, DEPT. OF TRADE & IND., INSOLVENCY–A SECOND CHANCE (Cm. 5234, July 2001), proposed to abolish administrative receivership, except in connection with certain transactions in the capital markets. Although the wording is not clear, it appears that the intention is for qualifying securitization transactions to be protected. The recent DTI Press Notice (P/2001/629, Nov. 9, 2001) clarified that these changes would not apply retrospectively to lending agreements in place when the legislative amendments come into operation. *See* David Milman, *The End of Administrative Receivership?*, 2002 INSOLVENCY LAWYER 1, 1.

8. Hill, *supra* note 5, at 526.

9. These deficiencies were offset by a guarantee provided by the Sarawak Economic Development Corp and by a letter of support from the Sarawak state government. *Id*. at 526–27. It is clear that even in whole business securitization, there is an important role to be played by the government.

10. Professor Hill herself queries how many firms will satisfy this element. *Id.* at 531.

pensable to the running of the company;

- companies frequently need additional financing, and it is not uncommon in Asia for companies to borrow from many lenders;[11] and
- monitoring by banks is generally poor.[12]

In Professor Hill's view, the primary benefit achieved by whole business securitization is the minimization of bankruptcy costs resulting from the agreement between the entire group of creditors when the loan is made concerning their respective rights and obligations if financial difficulties later arise. Additional benefits in Hill's view are the specialization benefit (with an active trustee taking the lead in the monitoring of the company) and the enhanced ability to access the capital markets.

However, the insolvency-related benefits in emerging markets may be less than Professor Hill anticipates. Where a company subject to a whole business securitization agreement defaults, an administrative receivership or receivership will frequently ensue. The insolvency-related cost savings that Professor Hill identifies seem more likely to arise in jurisdictions in which developed insolvency and secured transactions regimes enable such receiverships to proceed efficiently. It will be much more difficult for these cost savings to materialize in emerging markets that lack these regimes.

Overall, it seems to me, and I suspect that Professor Hill would agree, that frequent use of whole business securitization in emerging markets, especially in Asia, is at least a good decade away, if it occurs at all. In contrast, over the next ten years, as the matrix of factors that Professor Arner describes are put into place, the securitization of mortgages, as well as of credit card receivables and auto loans, will become much more common in emerging markets.

11. For background on the corporate insolvency laws and practices of eleven Asian economies, see Local Studies of Insolvency Law Regimes, *available at* http://www.insolvencyasia.com/local_studies.html (last visited Apr. 12, 2002).

12. However, as Professor Hill suggests, the trustee appointed pursuant to the creditors' agreement might be able to perform this task more efficiently. Hill, *supra* note 5, at 528.