ISRAEL SECURITIES AUTHORITY

Report of the Committee for examination of various aspects of Securitization (the issue of Asset-Backed Securities)

Submitted to
The Chairman of the Israel Securities Authority, Mr. Moshe Tery
And Chairman of the Israel Tax Authority, Mr. Eitan Rov

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Content

Main Recommendations of the Committee

The issue of asset-backed securities, known as securitization, is one of the more important developments that took place on world financial markets during the last years.
Generally, in securitization, a prospective cash flow generated by a particular group of assets is forwarded to the securities holders, in return for a present monetary payment. The techniques of carrying out securitizations, as well as business implications of securitizations are varied in nature.
During the last decade there was a rapid growth in securitizations, all over the world, which indicates the growing importance of securitization as a funding instrument and its advantages for both companies and investors.
At the same time the Israeli securitization market is underdeveloped, and is still in its infancy, mainly due to lack of proper infrastructure in law, accounting and supervision, that is essential for securitization. In the last few years parties interested in carrying out securitization or other transactions of similar nature have approached various supervising bodies with request to regulate the field and to remove the barriers preventing development.

In January 2003, the Chairman of the Securities Authority and the Tax Authority has appointed an inter-ministerial commission for the removal of barriers in the field of securitization (henceforth – the "Committee"). The Committee had included representatives of Authorities, which are responsible for the supervision of securitization, in order to deal with the task from a broader standpoint and to examine various aspects of law, accounting, taxation, banking and disclosure. The Committee had held numerous meetings and discussions with various representatives, both Israeli and foreign, in order to evaluate the nature of the securitization market, to learn what barriers are preventing its development in Israel, and to examine ways for their removal.
It is important to point out that the Report, submitted by the team appointed by the Minister of Finance for the reform of the capital market, under the chairmanship of Dr. Josef Bahar, had stated that the establishment of a securitization market within a banking system is a necessary supplementary step required to increase competition and to refine the capital market.[1]

The Committee Report has three goals:

One – to increase awareness and understanding of the importance of the securitization market in Israel, all its aspects included.

Two – to examine the existing situation in Israel and to establish what the barriers are preventing the development of the proper securitization market here.

Three – to make recommendations regarding both regulations and supervision that are required to allow the development of a regulated and fair securitization market that will ensure public interests.

It is important to point out that the report is founded on the premises that the development of a securitization market, based on sound supervision, as well as legal and accounting infrastructure, is welcomed for the Israeli market and its advantages

[1] Inter- Ministerial Report on the "Capital Market Reform" (Jerusalem, September 2004), p. 60

are many. Therefore the creation of definitiveness on the securitization market, by means of legislation and clear supervision rules, is imperative - without it the securitization market will remain stagnant.

The report consists of eight chapters.

Chapter 1 – brings together all committee's recommendations in an organized manner.
Chapter 2 – is an introduction, it displays structures customary for securitization, analyses advantages and disadvantages related to securitization trade, and brings a survey of securitization markets in Israel and in the world.
Chapter 3 – discusses various accounting aspects of securitization, in particular the classification of securitization as "sales" or "funding".
Chapter 4 - discusses various legal aspects of securitization, as well as existing and recommended laws related to this issue. The main recommendation of this chapter is – that it is desirable to settle securitization regulations in a separate legislation.
Chapter 5 – discusses taxation aspects of securitization, classification of transactions - as "sales" or "funding", discusses classification of securitization holders as capital holders or as dept holders and taxation of all the parties participating in securitization.
Chapter 6 – discusses idiosyncratic aspects of securitization carried out by the banks.
Chapter 7 - discusses the offer of asset-backed securities to the public, mainly the disclosure aspect required in regard to these bonds.
Chapter 8 – gives a short survey of the latent potential embedded in securitization of government projects.

Within the framework of each chapter, the committee has provided recommendations regarding matters discussed in that particular chapter.

It is important to emphasize that, for two main reasons, recommendations of this committee are only a starting point for the management of the securitization field.
First – the committee recommends regulating some of the issues by means of special legislation, which is the responsibility of the Justice Ministry.
The position of the Justice Ministry was presented to the committee, in regard to certain issues, although sometimes without an appropriate solutions for them.
Second – international experience shows that securitization market is very dynamic and is constantly undergoing change. Therefore continuous involvement of the supervising and legislative authorities will be required in order to deal with the upcoming issues.
Henceforth is the summary of the recommendations made by the committee in regard to asset-backed securities, securitization market regulations and the development of this financial instrument in Israel.

1.1 Recommendations pertaining accounting regulations.

Two customary accounting systems used in the world today – International accounting regulations and American accounting regulations – stipulate different rules in regard to securitization of financial assets.

The Israeli Accounting Standards Board is acting to match Israeli accounting regulation with the International regulations, and therefore, in accordance with request by the Committee, to regulate the accounting aspects of securitization, the Standards Board has published, in September 2004, a proposal to amend Standard no.23 that is based on the renewed International Standard no.39, which determines regulations for the derecognition of financial assets.

In light of the Standards Board's ruling, that Israel is to aspire to adopt the International accounting regulations as a whole, as many important countries in the world have done, it seems reasonable to accept this regulation in regard to the securitization issue. Yet, in light of the difficulties described in the report, that will come up with the immediate adoption of the standard, the committee has accepted the Standards Board's recommendation that the application of Standard no.23 based on the renewed Standard no.39 should be postponed until the year 2007, in an attempt to allow the securitization market to develop and adjust to stricter requirements of the international standard; while at the same time to learn from the accumulative experience in the application of the renewed international Standard no.39 in the world, and the ability of securitization's market to cope with stricter new regulations of this standard.

In the interim period, until the application of the proposed new standard, securitization transactions will continue to come under the American Standard 140 FAS law, which is the accepted practice in Israel.

The Committee also suggests that no retroactive regulations will be applied to securitization transactions after the start date of the Accounting Standard no.23, which means that all securitization carried out before the application of the Standard, will continue to be presented in financial reports in accordance with the American Standard 140 FAS (or any other accepted practice that will be valid on the date of application) even after the application of the Standard.

With that, a sweeping adoption of international standard in Israel, as planned by the Israeli Accounting Standards Board beginning in 2008, will require revision of transitional regulations. It is worth noting that transitional regulations of the International Accounting Standards no.39 state that in case assets have been derecognized from the balance, according to accounting regulations of the past, they will not be recognized anew in financial reports even if according to International Accounting Standards no.39 those assets would not have been derecognized.

There is no particular standard, in the world, in regard to securitization accounting from the transferee's standpoint (mainly SPA cases) and therefore since the transferring body in securitization is the bonds issuer to the public – the committee recommends formulating clear rules in regard to presentation and disclosure of assets that were transferred to SPE.

1.2 Legal recommendations.

The committee has found that legal certainty is essential for the development of a stable securitization market; therefore the lack of binding laws on this subject is a central factor that slows down the aforesaid market in Israel, and increases the danger of injustice toward the parties involved in securitization.

The chapter which deals with the legal aspect, in this report, debates a number of problems related to securitization. Committee's main recommendation regarding this matter is that Israel should follow other countries and produce a comprehensive and clear law, related to securitization (henceforth Securitization Law).

Where the Committee was of opinion that intermediate solutions are possible, until the enactment of the Securitization Law, it pointed that out in the report. Never the less most of the problems will be resolved only by means of legislation; therefore more than one alternative to solve them at present is presented.

1.2.1 Transfer of rights.

Three main issues that require regulation in regard to transfer of rights are: definitions of debtor's rights after transfer , a way of assigning accompanying rights that require registration (such as mortgage securities for apartment purchasing) and transfer of rights that haven't yet been finalized at the time of transfer .

Definition of debtors rights after transfer :

In accordance with the law all claims that stood against the Originator at the time of transfer of rights will also compel the SPE. Those possible claims toward the SPE may impinge the securitization. The limitation of the aforesaid claims will avail the separation between the transferred rights and the Originator, but at the same time it might impinge debtors' rights.

In order to balance the above stated concerns the Committee proposes to regulate, restrictions under the Securitization Law, regarding the rights of debtors to make, against an SPE, the same claims they had against an Originator; provided the following conditions are fulfilled:

- **a** The transaction is for the securitization of financial assets, i.e. the right to receive money on a predetermined date, which is not combined or conditioned by the Originator's liabilities, with the exclusion of marginal debits (non essential debits related to debt collection).
- **b** The transaction stipulates, a predetermined mechanism by means of which marginal debiting will be carried out, as aforesaid, by the service provider that was authorized by an SPE to do so and has given his written agreement to take the Originator's place, if the need arises. In some cases there is room to limit identification of the servicer for reasons of consumer protection.

We also proposed to clarify that in case the debiting of a debtor was fully completed, then the debtor will not be able to avoid the payment of debt only because the identity of the service provider has changed.

Transfer of accompanying rights that require registration.

The requirement to change registration of a guarantee required to secure a mortgage for purchasing an apartment, in order to transfer it to an SPE, is a major barrier in creation of a bond market, backed by mortgages.

As far as the Committee is concerned the solution to this problem may be found by means of:

- **a** To regulate that transfer of securities, which are the accompanying rights of a mortgage, either do not require registration or require an easier alternative registration (for example, registration with the registrar of companies, or with an alternative registrar that will be created for the purpose of registering securitized mortgages).
- **b** Reduction of high registration fees and shortening of the registration process.

Transfer of rights that are not yet finalizes by the date of transfer:

The Committee is of the opinion that there is nothing to prevent carrying out the transfer of rights that are not yet finalized (rotating securitization); in case the transfer has been registered in accordance with the law and was properly reported in financial reports of the Originator.

At the same time we propose to include a clear regulation, under the Securitization Law, that will allow transfer of rights that are not yet finalized; provided they are registered in accordance with the law.

1.2.2 Judicial structure of the SPE and rating of securities issued by it.

Presumably, in the short term, the most appropriate way of association for an SPE - is that of a private corporation established under the Companies Law. Since the structure of a corporation is not entirely appropriate for the characteristics required from an SPA, we propose to define a special status for the body issuing asset-backed securities as well as to regulate the functioning of this body and the right of its securities holders, all under the Securitization Law.

At present, until the legislation of the Securitization Law, the issuing of asset-backed securities to the public by the SPE will be seen as issuing of bonds and not as shares; therefore the SPE will be considered a private corporation, in accordance with the Companies Law.

1.2.3 Classification of Transactions as "sale" or as "loan" backed-up by mortgage.

The distinction between transfer by way of a "sale" and transfer by way of mortgage is very complex, and there is no clear definition for it under the general law. The ambiguity also exists regarding securitization, since this issue was not debated at all in the court rulings. Securitization cases, where a question of classification might arise, are the cases in which there is a continuous involvement by an Originator after the transfer of assets.

The Committee is of opinion that the Securitization Law must regulate the judicial position regarding the aforesaid, but at the same time the Committee didn't reach a conclusive conclusion as to what that the desirable solution should be. There are two possible approaches to this problem:

- **a** To stipulate that a sale of assets under securitization is not subject to the risks that remains in the hands of an Originator. This approach secures legal definitiveness, but such definition might not comply with economic and accounting reality.
- **b** To determine that the sale of assets took place only if the majority of risks related to these assets have passed from the Originator to the SPA. This approach reflects the economic reality, but such definition creates difficulty in stipulating a quantitative criteria and its implementation regarding the aforesaid.

The Committee is of opinion that at the time of legislating, a gap must not open, between the judicial interpretation and the accounting classification of the sale.

1.2.4 Operational aspects.

The Committee recommends stipulating a rule, within the Securitization Law, that will ensure operational separation between the Originator and the back-up assets. Those rules will settle, among other things, issues such as cash deposits in trust accounts of bond holders; dates and ways of payments to service provider and control over these payments; mechanism for the replacement of service provider, etc..

1.3 Taxation recommendations.

There are taxation implications of securitization for three parties – for an Originator or source corporation (hereafter in this section – source corporation), for an SPE (hereafter in this section Special Purpose Enterprise) and to the owners of privileges in them (rights holders). Two main question regarding taxation are relevant to the classification of securitizations: do we deal with a "sales" transaction or with a "funding" transaction; and do we have to classify the issued rights as capital or as debt.
The answer to these questions influences other tax related issues.

The tax chapter in this report debates these two questions, including possible alternatives to taxation, as well as a principal model for the proposed tax. The basic rule is – that where legal and accounting regulations classify securitization as a "sale" it should also be seen as such for tax purposes. Never the less, in light of the economic nature of the deal, in some transactions with preliminary agreement of the tax authorities, it will be possible to designate securitization, as "funding", for tax purposes, if the issuing of bonds was done in advance by a source corporation.

Henceforth is the taxation model of "sales" and "funding" securitizations.

Taxation principals for a "sale" securitization.

Terms required for the designation of securitization as a "sale":

1. A new, Israeli based, designated corporation (SPE) has been established for securitization purposes (henceforth - Specific Purpose Enterprise). A case where an SPE has been established outside Israel will be examined separately.
2. The sole purpose of the designated corporation is to facilitate the securitization, which means: to issue bonds to investors, to purchase cash flow rights from a source corporation, and to transfer money from cash flow to the rights' holders in the designated corporation.
3. In accordance with accepted accounting regulations securitization has been designated as "sale".
4. According to the terms of securitization, when the period for receiving cash flow expires, a designated corporation will be dismantled and the remainder of its assets, if any, will be transferred to its rights holders.
5. A clear separation exists between securitization and provision of services.
6. General rights (of various rates) and service right (single rate) have been issued by the source corporation. Residual rights will be defined separately.
7. Avoidance or un appropriate reduction of tax payment - is not the object of securitization.

Taxation principals of securitization classified as sales.

Terms required for the designation of securitization as a "sale":
In a source corporation:
1. In case the following conditions are fulfilled securitization will be regarded as a "sale".
2. Transfer of rights to a designated corporation will be regarded as profit, on the date of securitization, by the source corporation since profit or loss will be determined on its behalf.
3. In regard to a debt component, if any, that remains in the hands of the source corporation - loss or profit will not be recognized because of the sale of rights. The rights will be transferred to a designated corporation according to their cost. When and if the source corporation sells the aforesaid bonds, then the loss/profit, in regard to the sale of the remainder of the rights will be recognized.
4. Servicing Agreement, that accompanies a securitization, will be taxed separately from the securitization itself and only for the period of service

rendering to a designated corporation (securitization period – as a rule).
5. An exemption certificate for tax clearing at source will be given to a source corporation regarding the intake it receives during securitization from the clients, in order to transfer it to a designated corporation.
6. Securitization (the sale of rights to receive future cash flow) will not be subject to VAT. Future transactions, subject to securitization will be reported by the source corporation, including issuing of tax receipts to the clients of a source corporation, and tax payment required in regard to these transactions.
7. As was confirmed by the Supervisor of Banks, the handling of taxation in regard to profit/loss recognition in banking corporations under the supervision of the Supervisor of Banks will be similar to the handling of accounting.

In a designated corporation:

1. Designated corporation will record in its books every asset acquired (rights for cash flow) according to the sum paid for it (market value on the day of securitization).
2. Designated corporation will be exempt form corporate tax on its income (the taxation will be in the hands of the residual rights holders).
3. Designated corporation will be given an exemption from taxes deducted at source, for income received from a source corporation as part of the securitization.
4. Classification of a designated corporation, regarding VAT tax law, will be determined in accordance with the source corporation's classification (or in accordance with the residual rights holders classification) as a "dealer", "financial institution" or "a non-profit corporation". In case a source corporation and a designated corporation will be registered as a "dealer", both of them may register as a consortium in accordance with the VAT Law.

In regard to investors in a designated corporation:

Holders of general rights in a designated corporation – will be regarded as debt holders and not as capital holders (generally, they will invest by means of bonds issued by a designated corporation). Holders of general rights will be subject to taxation of interest received on the rights they hold, or will be exempt in accordance with section 9(2) of the regulations, subject to stipulated provisions. Upon the issuing of a securitization clearance, regulations of separation will apply to the prime and the interest and therefore reporting will be on the basis of accumulation.

Holders of residual rights in designated corporation :

- **a** Holders of residual rights in a designated corporation will be taxed on the profits of a designated corporation that will be calculated as their income profit.
- **b** In calculating profits the income component from cash flow will be taken into consideration and in calculating expenses the interest on the rights of dept holders will be taken into account.
- **c** Taxation of residual rights owners, in regard to the income ascribed to them from the source corporation will be on the basis of accumulation.

d Restrictions might be stipulated in regard to identity of the residual rights owners, in order to ensure tax payments to the treasury.

e Actual distributions to residual rights owners will not be taxed (as a partner in a partnership), since the income from which it originates has been already taxed on ongoing bases, with the exception of a distribution that is over the original surplus price of the residual rights owners.

f Every year an adjustment of a surplus price, of the residual rights, will be carried out for taxation purposes of the residual rights owners (similarly to a value estimation of a partner's rights in a partnership), in such a way that a profit ascribed to a residual rights owner increases the original price, while an ascribed loss lowers an original price to zero, cash distribution lowers an original price and so on.

Taxation principals of the securitization classified as "funding".

Terms of granting a preliminary permit:

1. A new and separate SPC corporation has been created for securitization purposes, with the exclusion of a revolving securitization (therefore – "designated corporation").

2. The sole purpose of a designated corporation is to issue bonds to investors, to acquire cash flow rights from a source corporation and to clear cash flow to bonds' holders. All the assets of a designated corporation – are the rights for getting the cash flow and its liabilities are the bonds.

3. Securitized assets are one of the following:

a Assets, not considered financial assets, are not included in a property that is subject to securitization, according to the regulations under LAS 39/FAS 140, ("financial assets" means – loans, debts to clients, financial leasing, etc.). Hence, according to this alternative it is possible to securitize cash flow from operational assets, such as rental income, operational leasing, etc.

b Financial assets, which according to accepted accounting regulations, are not regarded as sold assets by a source corporation (in this alternative the reasons for the assets being regarded as not sold shall be examined).

4. As part of securitization bonds will be issued to investors (possibly of variable rate).

5. Full extent of residual rights (usually share capital) in a designated corporation will be own by the source company. Residual right will be defined separately.

6. With full remuneration of bonds a designated corporation will be dismantled and all its remaining assets and cash will be transferred to a source corporation.

7. The return on the issuing of bonds will be used by the source corporation for its business activity.

8. Avoidance or un appropriate reduction of tax payment - is not the aim of securitization.

Taxation principals according to a pre-rolling certificate.

1. If the following requirements are fulfilled, securitization will be seen as bond issuing within the framework of the source corporation. Therefore transfer of rights from a source corporation to a designated corporation will not be considered as "sale" by the source corporation.

2. All income, expenses, assets and liabilities of a designated corporation will be regarded, for income tax purposes (including Inflation Adjustment Law), as income, expenses, assets and liabilities (accordingly) that belong to a source corporation. A designated corporation will not have debt or income for tax purposes.

3. With full remuneration of bonds a designated corporation will be dismantled and all its remaining assets and cash will be transferred to a source corporation. As aforesaid, transfer and dismantling will not be taxable.

4. Bonds held by anyone other than a source corporation will be classified as dept and not capital.

5. A source corporation will be given a certificate of tax exemption at source, in regard to the income received from its clients that is subject to transfer to a designated corporation, in accordance with the rules that will be stipulated.

6. A designated corporation will be given a certificate of tax exemption at source, in regard to the income received from the source corporation.

7. A designated corporation will be required to deduce tax at source on the interest payments to bond holders, subject to specific certificates or particular exemptions bond holders are entitled to, in accordance to the law.

8. In case a source corporation will enter ceasing of payment proceedings, the date of payment ceasing, in a source corporation, will be seen as profit taxation date in regard to the relative portion of the profit resulting from a transfer of rights to a designated corporation that has not been taxed as part of the current cash flow.

9. Sale of residual rights (generally, a share capital) in a designated corporation by a source corporation will constitute taxation date in regard to the remainder of the securitization money that were not yet taxed, and tax regulations of a "sale" securitization will apply, in accordance with required amendments (in this case a preliminary approval by tax authorities will be required).

10. A designated corporation will not be required to carry out a separate registration, in accordance with the VAT Law. The source company will continue to report, to issue tax receipts and to pay VAT that stems from securitization related activities.

11. In regard to securitization of cash flow from rental income of real estate, with long term leases, and where investors (bond holders) are promised a large part of the asset's value by the end of securitization, the transactions will be examined separately, also in light of the regulations stipulated under the real estate taxation law.

The Committee recommends that the above stated principles will be incorporated within the framework of legislative amendments.

1.4 Recommendations related to banking.

All over the world, banks act as Originators, Transferors, recipients and service providers in securitization transactions. Their involvement raises idiosyncratic questions. Henceforth are the recommendations made by the Committees in regard to securitization by the banks:

1.4.1 Accounting presentation of securitization.

In accordance with recommendations by the Israeli Accounting Standards Board, International Standard IAS 39 will come into effect in 2007. Until then the banks are required to act in accordance with the American Standard SFAS 140, as it is published by the Supervisor of Banks and as it is implemented in financial reports of the American banking system.
After IAS 39 goes into effect in Israel, its regulations will not apply retroactively on securitizations that were carried out by the banks before its application in Israel. Those securitizations will continue to be reported in financial reports of banking corporations according to the American Standard SFAS 140.
After the publication, in Israel, of International Standard IAS 39 as binding, the Supervisor of Banks will be able to reconsider regulations regarding reporting of securitizations carried out after the new standard came into effect in financial reports of banking corporations.

1.4.2 Credit Enhancement for bonds redemption.

- **a** A banking corporation that carried out a transfer of financial assets under the securitization shall evaluate, on the date of transfer, the worth of rights retained in those financial assets according to their relative fair value. In case the remaining rights are rejected for the benefit of higher valued rights in the transferred assets (henceforth – rejected rights that have been retained), such a fact has to be taken into consideration at the time of fair worth valuation of the rights.
- **b** The fair value of rights that have been retained shall be calculated on the bases of reasonable, conservative valuation assumptions that can be objectively verified. An accurate record, of proper calculations of the fair value and of the assumptions they are based on, must be retained. The calculations must be based on the standards set by the US banking supervising authority[2]. In case it is impossible to calculate the fair value, that can be objectively verified, the rejected rights that have been retained must be scratched immediately (the way of handling a transfer of financial

[2] see – "Interagency Guidance on Asset Securitization Activities" (from 13.12.99) where it is stipulated: " This guidance …emphasizes the specific expectation that any securitization related retained interest claimed by a financial institution will be supported by documentation of the interest's fair value, utilizing reasonable, conservative valuation assumptions that can be objectively verified. Retained interests that lack such objectively verifiable support of that fail to meet the supervisory standards set forth in this document will be classified as loss and disallowed as assets of the institution for regulatory capital purposes."

assets, when it is not possible to fairly evaluate their worth, is clarified in Standard 140 under sections 71 and 72).

c After a principal recognition of the rejected rights that have been retained, the remainder balance of the rejected rights that have been retained will be deduced, according to the straight line method, during the average redemption period of the rejected rights, which may not extend over the period of three years from the date of their creation.

d On every reporting date a need to devaluate the rejected rights must be re examined.[3]

e In case, after the securitization, part of the rejected rights intended for parties non-affiliated[4] with a Transferor have been sold to, the remaining rejected rights will be valuated according to the accepted accounting standards.

f Until the implementation of recommendations made by the Basel Committee II[5], a bank will not invest in securitization bonds that are not of the affiliate, with the exclusion of higher valued upper tranch bonds.

1.4.3 Prohibition on repeat acquisition of loans transferred by a bank to an SPE.

The transferring bank will not be allowed to by back, directly or indirectly, the loan that was sold by him to an SPE, with the exception of fraud cases. Never the less, when a very short period of time remains on the SPE loan portfolio (for example in the last year of a 10 year term or when a remaining unpaid balance on the loan is 10% of the original balance), and if it is allowed by the originally established securitization agreement, the transferring bank will be allowed to clean up and to buy the remainder of the loans from the SPE, according to its fare worth. That in order to save on management costs of the loans' portfolio that has been securitized.

1.4.4 Prohibition on liquidity support of an SPE.

In case there are liquidity problems at the SPE, the transferring bank as well as the affiliates will not be allowed to extend, directly or indirectly, resources to support the liquidity of the SPE. Liquidity risk, if happens, falls squarely on bonds' holders, or on third parties not affiliated with the

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[3] See – EITF 99-20 " recognition of interest income and impairment on purchase and retained beneficial interests in securitized financial assets"

[4] Affiliates means: 1) According to the American Accounting Standard no.57 – a party controlling a corporation, or controlled by a corporation or under mutual control with a corporation, directly or indirectly by means of a broker or a number of brokers. 2) Provident Funds and Mutual Trust Funds – managed by the Transferor or parties that are considered close to him, according to paragraph 1) above.

[5] Regulations in regard to the minimal capital ratio that have been stipulated by the Supervisor of Banks in Israel are based on the Basel Committee recommendations for minimal capital ratio calculations, first published in 1988. In June 2004, the Basel Committee has published new recommendations for minimal capital ratio calculations (Basel Committee II), which are meant, among other things, to adjust the minimal capital ratio calculations to progressive methods of risk management, and to clarify the management of complex transactions, such as securitizations.

transferring bank (such as parties supplying "liquidity support" instruments for bonds).

1.4.5 Bank as a Servicer.

Regarding loans sold to an SPE at securitization, the transferring bank may continue to act only as Servicer and to present a servicing contract in financial reports in accordance with American standard 140 only in case it receives proper compensation for its work.
In order to safeguard the interests of securitization lenders, it must be stipulated that at the time of Servicer replacement the alternative Servicer shall be a corporation to which regulations of the Supervisor of Banks, in regard to lenders rights, shall also apply.
A lending bank shall not be barred from implementing sales accounting in regard to securitization in which it acts as an SPE Servicer, if its considerations are accepted under the provisions of the American standard 140.
Until enough experience is acquired and regulations are formulated by the Supervisor of Banks, regarding a transferring bank who is also a Servicer, the Supervisor of Banks shall examine securitization and confirm the following:

- **a** The determined fee is appropriate for the service provided
- **b** The considerations enacted by the servicer are within the provisions of the American standard 140.
- **c** Arrangements have been made to safeguard the interests of lenders in case of their loan's sale.

1.4.6 Loan portfolio composition and the prevention of "Cherry Picking"

In order to prevent a negative impact on the credit portfolio of the transferring bank, a selective sale of "good" loans to an SPE will be prohibited. Never the less it will be possible to sell to an SPE a loan's portfolio that have been randomly chosen from specific categories (for example dollar linked loans, index linked loans, non linked loans, housing loans, apartment insurance loan, car purchasing loan, etc.)
All that providing that the quality of a loan will not act as criteria for its inclusion or exclusion from the portfolio offered for sale.
Aforesaid not withstanding, at the time of the mortgage portfolio sale, in which an allocation for bad dept is calculated relative to the lagging on return payments[6], the Supervisor of Banks will allow the transferring bank to randomly exclude, from the chosen portfolio, loans which at the time of securitization are considered to be lagging behind.

[6] Allocation for lagging payments is a system described in appendix to Regulations of Proper Banking Management, amendment 314 "handling of problematic debts"; according to it banking corporations are required to calculate allocation for bad mortgage debt according to the rates stipulated under the regulations. In general, according to this system the longer the lagging on mortgage – the bigger the allocation required from the bank is.

1.4.7 Restrictions on the transactions with affiliates.

Affiliates of the transferring bank (such as provident funds, trust funds that are owned or managed by them) will not be allowed to buy bonds issued by an SPE in the securitization in which the aforesaid bank took part.

1.4.8 Gaps in the period of remuneration.

- **a** Revolving securitization – the Supervisor of Banks will authorize short term revolving securitization of securities, such as credits on credit cards.
- **b** Risk transfer by means of securitization will not be recognized as a sale in case the effective period of bonds remuneration is shorter than the effective period of the securitized credits remuneration. For example, the bonds have an effective remuneration period of 3 years while the loan's portfolio has an effective remuneration period of 6 years.

1.4.9 Rights borrowers.

The rights of a bank borrower are determined in accordance with the general law; a special law is applicable to some borrowers of a banking corporation, in accordance with the existing practice and banking management regulations of the Supervisor of Banks.
The borrower's position, as in a case where he gets credit for housing by securing a mortgage for an apartment, will not worsen because the bank have sold the mortgage, the borrower had acquired from it, as part of the securitization. In every securitization, appropriate regulations will be made for each specific transaction, which will ensure the rights of borrowers whose mortgages have been securitized.

1.5 Recommendations regarding Disclosure and trade on the Stock Exchange.

The Committee is of opinion that at this point in time there is no reason not to implement existing disclosure regulations pertaining securities, in regard to the issuing of asset-backed securities.
It is reasonable to presume that in the future, after the securitization market will develop, the need might arise to regulate specific rules regarding this issue.

Never the less, we propose, that in order to gain significant disclosure privileges - the point of which is to avoid describing all of the Originator's assets and to gain a release from the application fee for issuing a permit to publish a forecast - compliance with the following rules will be required:

- **a** The Accounting Standard, valid at the time of the proposal, recognizes assets derecognition from the Originator's balance, all or in part, and the SPE reports are not integrated into the Originator's reports.
- **b** The Originator and the SPE are not affiliated, except for their affiliation

for the purpose of securitization (which might also contain affiliation for providing services).

c The group of assets will be discrete and will include financial assets only.

d Existence of a management control system that insures the transfer of funds to SPE and their safekeeping for the benefit of the bonds' holders.

An offer of asset-backed securities that will not comply with these requirements will be required to submit additional information regarding the Originator and will not benefit from the lenient disclosure regulations.

In addition we propose:

a To publish guide lines regarding Originator's report, when the Originator is not a reporting corporation, for the purpose of securitization.

b To amend securities regulations (a request for Application to Grant a Permit to Publish a Prospectus) 1995; and to regulate a temporary ruling for the period of two years, according to which an exemption from fee payment for issuing a Permit to Publish a Prospectus for assets backed by mortgages will be granted according to the aforesaid regulations - in order to encourage the use of this instrument.

1.6 Recommendations regarding securitizations of government projects.

The committee had examined securitization feasibility of government projects and found out that there are a lot of advantages in bonds backed by cash flow from government projects.
Additional steps taken lately, such as launching a system of "institutional continuity" by the Stock Exchange or securing a special track for shelve prospectus procedures in the Securities Law, might also help to develop this field further.

Chapter 2

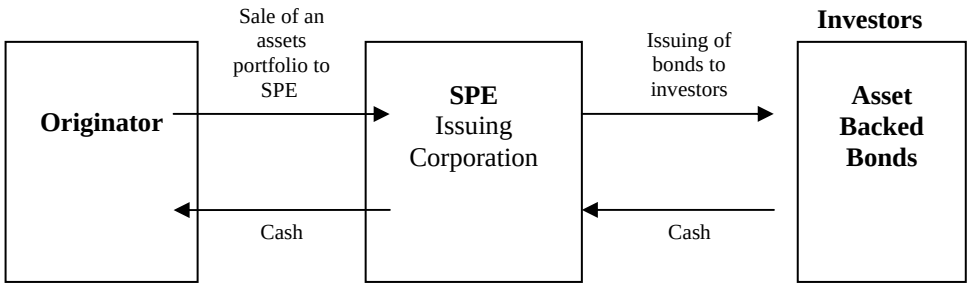
FOREWARD

Asset-backed securities - are bonds whose remuneration (prime and interest) is guaranteed by a predefined cash flow, for a short or long period of time that is expected to be generated by a specific group of assets. In the last few years the asset-backed securities have become one of the more important financial instruments on world financial markets, a fact that indicates their growing importance as a funding instrument and their advantages for both issuers and investors. The subject of issuing asset-backed securities (or securitization) became a center of debate for those who are active on the financial market as well as for various supervising authorities. In spite of the accumulated world wide experience in this field, we can still state that securitization is continuing to raise a lot of intricate questions and to challenge conventional wisdom in such areas as - law, accounting, funding regulations, etc.. Despite of the positive aspects of securitization, the abuse of the system might lead to

a financial collapse of the institutions involved in securitization, as well as to a negative impact on investors and third parties.

2.1 Basic Concepts of Securitization.

Structural diversity of legal and financial aspects, related to securitization, stems from the fact that securitization is planned in accordance with legal considerations as well as accountancy and tax considerations, which vary from country to country. Still, there are a few traits common to all securitizations. The beginning of any asset securitization is in a legal entity, commonly known as the Originator, which identifies and isolates assets it wishes to securitize. The Originator creates, or is assisted by, a designated legal entity that carries out the securitization (henceforth SPE or Special Purpose Entity)[7]; in order for it to be legally and economically separated from the Originator, so that it won't be a subject to the risks of insolvency. The Originator transfers a group of assets to the SPE which issues bonds, backed by cash flow from these assets, to investors. The intake received from investors is transferred to the Originator.



A. Assets that are subject to securitization.

As aforesaid, the start of any transaction is in definition of assets designated for securitization. Asset-backed securities may come in the form of financial assets that are recognized as such in the Originator's balance, for example - dept of clients, loans and mortgages, credit cards and renting rights; or the assets may come in the form future cash flow, which is not recognized as an asset in the Originator's balance but originates from non financial assets in his possession - such as the agreement rights from an operational leasing of vehicles, real estate leasing rights and so forth.[8] These assets are characterized by a stable and foreseeable cash flow that is used to make payments of both the prime and the interest to the holders of securities; usually a large group of assets is chosen in order to reduce the risk of non payment. After a suitable group of assets has been chosen for securitization, the Originator isolates this group and prepares its transaction to an SPE by means of a "True Sale". This transaction is based on a lawyer's opinion, which states that a sale of assets indeed takes place and as a result of it the assets are no longer under the actual risk of bankruptcy. The accepted terminology for this matter in the US is - bankruptcy remote.

[7] Other terms used for this purpose are: SPV – Special Purpose Vehicle, or SPC - Special Purpose Company (when talking about a Company). These terms will be used in this report.

B. **Accepted structures of securitization**.

In the United States an SPE is usually established by the Originator as a separate judicial entity for the purpose of attaining three main goals:

- to serve as a means of conversion of Originator's assets, into a one time cash flow generated from the issuing of bonds to investors
- to protect the investors from an SPE bankruptcy [9]
- to protect securitized assets from the creditors of the Originator

The legal means for separating the SPE from the Originator are varied and are chosen in accordance with the laws applicable to a particular securitization.
The SPE itself may be a corporation, a partnership or a trusteeship.

It should be pointed out that it is possible to issue asset-backed securities in a way which is not designed to attain the aforesaid goals; in such cases the transfer of assets to an SPE is not required. Securities may offer a return based on a future cash flow, which certain assets are expected to generate, without isolating them from the other assets. A prominent example of this is "project related bonds": a corporation looking to raise capital, for a particular venture, issues' securities whose return is related to the profits derived from that venture.
The issuing of this type of bonds is already possible today; therefore this report will not deal with them and will mention them only in passing.

A number of existing structures for carrying out of securitization.

1. Single-Step Securitization and Two-Step Securitization

Seemingly securitization does not require more than a transfer of assets to an SPE in return for cash. This simple transaction structure, is known as a Single-Step Securitization, and it falls under the regulations of the American Standard FAS140[10], but it was found insufficient in cases where an Originator retains a long tem involvement with the SPE (for example in cases when he himself acquires the SPE issued bonds).

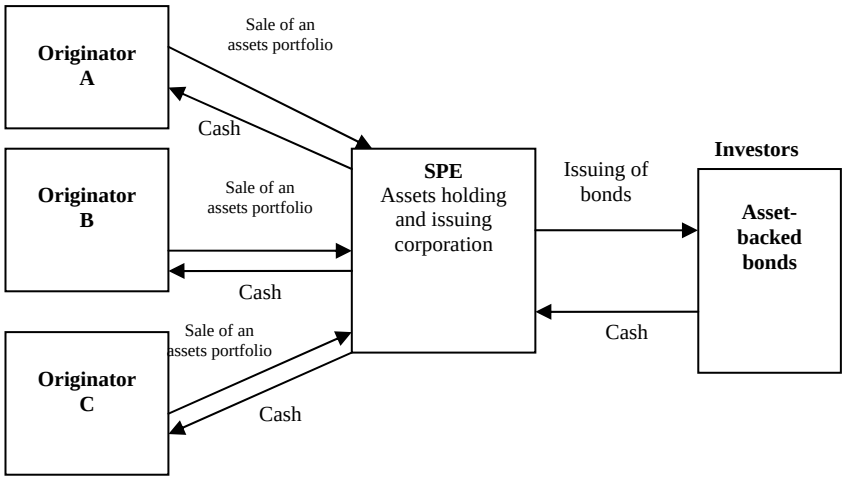
In light of the aforesaid, a more complex technique of securitization has developed in the US. It is known as a Two-Step Securitization or a Multi-Tier Structure. Under this structure an Originator transfers assets to an SPE by means of a "real sale", which in turn transfers the assets to another SPE that issues the securities.

2. Multi-seller Securitization Conduit

This type of securitization ties a number of different Originators to an existing SPE, which in turn issues asset-backed bonds that have been sold to it by those

[8] The differentiation between financial assets and cash flow from non-financial assets is related to the accounting handling of securitizations, see Chapter 3.
[9] The misgiving in this case is that an SPE may file for a voluntary bankruptcy.
[10] See Chapter 3.2 of this Report

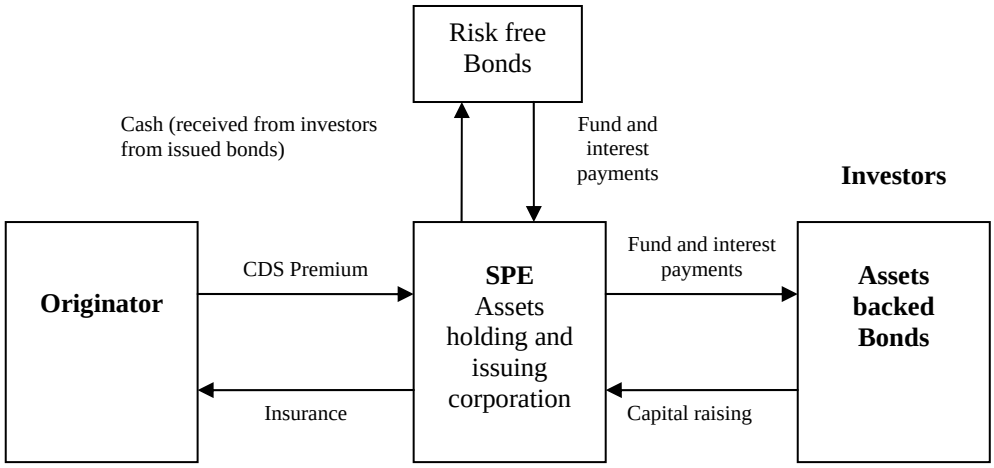
same Originators. The structure of this transaction allows different Originators to reduce the costs of securitization by selling assets to an existing SPE that deals in buying assets and issuing bonds to investors. Besides the reduction in securitization costs, this structure brings into existence a more varied portfolio of assets, which allows investors to enjoy a wider spread of risks. On the other hand this structure increases a legal risk accompanying a deal, since every creditor of the participating Originators is a potential plaintiff which might demand the transfer of the SPE assets into his possession, in case his indebted Originator has gone bankrupt.



C. Synthetic Securitization

Contrary to a regular securitization - synthetic securitization does not require the transaction of assets from an Originator to an SPE; in fact it is an insurance deal by nature. In a synthetic securitization an SPE issues bonds of nominal value equal in value to an Originator's portfolio of assets, the return on this issue is invested in the non risk assets (government bonds). The Originator purchases insurance from an SPE and in return pays him an insurance premium (CDS - Credit Default Swap).

In case the Originator is not declared insolvent, the investors will get full return on the government bonds in addition to the insurance premium the Originator has paid.
In case of partial insolvency of an assets portfolio, an SPE will sell part of the government bonds, equal in value to the worth of the insolvent assets, and the sum will be transferred to an Originator. For example - if the issue is the dept of clients, then following a 2% insolvency of this debt an SPE will sell 2% of its government bonds and transfer the return to an Originator. In other words, with insurance realization the SPE bond holders carry the cost of insurance. Since in synthetic securitization there is no transfer of assets from an Originator to SPE, no difficulties will arise from this type of transaction, contrary to a regular securitization. Therefore this report will not discuss synthetic securitization.



Any of the structures described above may be used as a platform for "revolving securitization". In revolving securitization assets that back the bonds, change during the bonds' life span, in accordance with a criteria defined in advance. The reason for it is that sometimes the issued bonds have a longer life span then the securitized assets. For example, if a request is made to securitize client's dept payable in three months, it is probable that its redemption date will be earlier than the redemption date of the bonds. Revolving securitization is designed to solve this problem: the return received as a payoff on securitized assets is used by an SPE to purchase other securitized assets similar in nature to the original ones. In this way a cycle of securitized assets is created until the end of the bonds' life span, when the fund is repaid to investors. In this way it is possible to issue long term bonds backed by financial assets that have a short date of payment.

Security cushions and external securities.

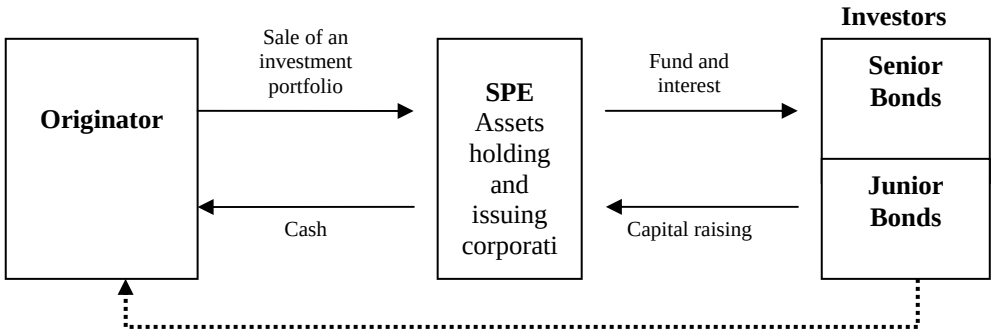
Various credit enhancement devices are often used in order to reduce an SPE risk to find itself without enough resources to pay bond holders and to increase the probability of a full debt return as well as to increase the rating of an SPE bonds. It must be pointed out that dept rating is a constant component in securitization; lack of rating raises difficulties in selling asset-backed bonds. Rating companies examine the quality of assets and publish credit ratings, which are based on a number of factors including quality of assets, level of securities and other credit enhancement devices.

For example, it is possible to determine that there is an over-collateralization of assets relative to the bonds they require to cover in order to protect investors from non payment or late payment. Bonds may also be backed by a banking guarantee, by insurance or by a guarantee issued by a financial institution.
Another conventional instrument to raise credit rating (for part of the bonds) is to divide them into senior and junior bonds.[11] On the date of transfer of assets to an SPE, junior bonds are acquired by a third party, affiliated with the

[11] The division can be in 2 tranches or more, at different rates of superiority.

Originator or by the Originator himself, who will not receive interest or prime income until holders of the senior bonds receive all the interest and prime income to which they are entitled to. This means that junior bonds act as a protective envelope by virtue of them being first to absorb loses on securitized assets.

In accordance with this outline, asset-backed securities may provide a range of preferences, redemption dates and return rates for investors. For example, in a securitization containing two rates of bonds, one rate may (senior bonds) provide preference in getting cash flow from assets, while another rate (junior bonds) will provide a higher interest rate.



Junior bonds acquisition by a third party does not raise any specific problems, while the acquisition by an Originator raises serious questions in regard to proper accounting presentation of this transaction in his books and the carrying out of a "true sale" of assets.

D**. Originator as Servicer.**

In many securitizations the Originator is also a servicer which secures cash flow that originates from the securitization of assets. For example, in securitization of loan mortgages, the Originator might also collect payments from loaners, deal with lagging payments, etc. Financially, it is logical for the Originator to act as a servicer, considering the fact that he had created or held the assets in the past. However, in this case a question of "true sale" has a particular significance, since a certain amount of control over the assets remains in the hands of the Originator after their sale. Although it is customary to decide in advance that in case the Originator encounters difficulties and is not able to properly fulfill his function as servicer, he will be replaced by another servicer; even so certain interdependence between the Originator and the SPE may still remain.

2.2 Advantages and risks of securitization.

Securitization became prevalent world wide since there are a number of advantages embedded in it both for investors Originators. As far as an Israeli market is concerned, securitization may help to solve a number of structural centralization problems, related to the funding of the business sector - problems that harm the sector's stability and effectiveness.

2.2.1 Advantages from the Originator's point of view.

1. New sources of funding.

Low credit rating makes it difficult for many corporations to raise funds, weather by the issue of shares or by the issue of debt. Securitization of assets is an inexpensive way to raise funds from the public. The main advantage of securitization is - the possibility to separate between the risk of investing in an Originator's securitization and the overall risk of investing in an Originator. This separation of risks allows those who invest in the SPE bonds to lend it (the SPE) money at the rate that takes into account the risks related to the SPE and the securitized assets only, without taking into consideration the overall risk of the Originator - a fact that will be expressed in the credit rating accompanying the securitization. This rating reflects a relatively low financial risk of the SPE investors and allows the Originator to raise inexpensive funding. The rating gives investors simple criteria for risk estimation, which also lowers the cost of capital raising. Nevertheless, it is important to remember, that at the same time the risk facing the creditors of the Originator[12] might increase, and in this context a question of this arrangement's propriety arises since it prefers the SPE debtors (read - investors) *prima facie* the Originator's debtors.

Financing Originator's business transactions by means of securitization is, therefore, a substitute for banking financing; instantaneous raising of capital for business expansion and investment becomes feasible, securitization also vacates credit lines for other uses and diversifies possible sources of funding.

2. Improvement of liquidity balance and derecognition of asset from the balance.

Securitization, which according to the accounting regulations complies with the rules of assets derecognition – liquefies Originator's assets the direct result of which is an exchange of assets for cash. Contrary to a regular funding deal where a loan is registered together with an undertaking in the Originators books, in securitization which complies with accounting derecognition rules, further to turning assets into liquid funds and their derecognition from the Originators balance, the liability remains inscribed on the SPE books only and not on the Originator's books. Namely, securitization obtains funding without an inscribed liability. That in itself means that liquidity balance (cash, and cash worth divided by current liabilities) rises.

Securitization might reduce credit risk, interred in banks' assets and to assist banks and other financial institutions, which are subject to capital adequacy requirements, to reduce the amount of capital they have to raise in order to comply with these requirements.

The intent of capital adequacy requirements is to ensure that financial institutions will have enough capital to support or absorb the risk of loses, in

[12] On the face of it the creditors of the Originator are not supposed to be affected since an immediate compensation is received for the sold assets. The risk is related to the fact that the intake can be used by the Originator in a way that might destabilize the creditors.

case the assets are not sufficient to cover those loses.
For example, Basel International Standard that requires capital adequacy from banking corporations has been adopted in Israel. In accordance with the rules laid down by the Bank of Israel, which are based on Basel rules, a banking corporation is required to set aside 9% of its capital toward covering the credit risk to which it is exposed[13]. As aforesaid, a banking corporation may ask to subtract (derecognize) the loans (such as loans for home purchasing – mortgages) from a bank's balance - by means of securitization, and by so doing to reduce substantially the credit risk and the minimal amount of capital that it has to set aside, in accordance with capital adequacy requirements.

3. Focusing on operational income.
Next to its major objectives, the securitization market can help companies to focus on their main field of activities, such as an ongoing business management and generation of cash flow, and to terminate other financial activity.
For example, in a Multi-seller Securitization Conduit model, a financing and issuing activity is carried out by a professional body that specializes in it.

4. Structural advantaged of securitization for the Israeli economy.
Israeli capital market is characterized by over centralization and by intertwinement of activities that create potential conflict of interests. Centralization of the Israeli banking system is one of the highest in the world; further more in the last few years there was an increase in this centralization tendency – particularly in the field of banking credit[14]. As far as an overall extension of credit goes, issuance of asset-backed securities might lead to a shift in the center of gravity - away from the banking system and toward business firms, as well as to increase the competition and to decrease the market force of banks, in this field. At the same time creation of a favorable competitive structure will be to the general public's advantage, will improve the ability of business firms to finance ongoing activities and will decrease the risk of economic instability, related to centralization; it will also contribute to the growth of the private sector. In addition to the aforesaid, large business institutions that have exhausted their credit line with the banks, due to a single borrower limitation or due to limitations imposed on group borrowers, will be able to raise capital or debt via a supplemental channel.

2.2.2. Advantages from the investors' point of view.

1. Diversification of financial instruments.
Securitization of assets makes it possible to create variety of financial instruments, some of which will be very attractive to the general public, due to a relative stability of cash flow from backing assets which profit both the prime and the interest of the bonds' holders. Grading component also lowers the risk of acquiring asset-backed bonds, since risk allocation is estimated

[13] Due to a credit risk in some financial instruments the banks are required to hold a lower rate of capital in such credits as mortgages – minimal capital required is 4.5%
[14] see the Inter-Ministerial Report of the Capital Market Reform. (Jerusalem, September 2004), p.13

by expert organizations. Opening a channel of financial investment in asset-backed securities will allow wider risk dispersal, which exists in investor's investment portfolios and in cases when an SPE issues bonds backed by a number of investment portfolios from different Originators, a specific risk of each and every portfolio will be dispersed too.

2. Removal of brokers from the capital market.

Securitization allows companies to forgo mediation of traditional third parties in order to raise capital from the public; it allows them to obtain cheap financing without involvement of a broker who mediates between companies and financial markets. Securitization reduces the costs, pertaining to the deal, charged by financial institutions acting as brokers.[15]

For illustration purposes, a short survey of the Israeli mortgage market and the way it operates – is useful. In this market, mortgage banks operate as brokers between investors and borrowers (those who take out mortgages), however they do not link a particular borrower to a specific investor, but hold deposits as part of the bank's sources and lend the money to those who are interested in a mortgage. The lack of overlapping between deposits and loans creates a problem, since most of the loans for housing are – long term, while most of the deposits are for short or intermediate term.

Turning mortgages into securities, by means of securitization, may help accomplish several important objectives such as

- ✓ Create an infrastructure for financing the loans, of those who are eligible, by means other than a state budget
- ✓ Reduce the cost of financing the loans extended by mortgage banks, since financial brokerage will be carried out by means of a more efficient capital market
- ✓ Create new, long term financing channels
- ✓ Create an active market where mortgage-backed securities will be traded
- ✓ Investment in housing loans in Israel will become more attractive to foreign investors.

Please note, that Talmon Committee had examined the possibility to create a secondary mortgage market in Israel, and its recommendations were published in1998. The Committee's conclusions weren't unequivocal, although the creation of a secondary market was indeed seen as a positive instrument for market optimization. While the mortgages themselves will be created on the primary market (namely – loan contracts), the sale of those mortgages to investors, shall be carried out on the secondary market. This can be done by means of direct sale of mortgages to investors or by means of securitization of mortgages. For instance, there is an established and highly developed secondary market for mortgages in the US, the volume of investment in which, in the year 2004, has reached 1.76 trillion dollars. From its inception this market was characterized by strong government involvement, although in the late 70's a secondary - private market for mortgages was initiated by large investment banks. Positive by-products of

[15] We would like to point out that in order to carry out securitizations a different type of brokers will be required, such as SPE's, trustees, underwriters and rating companies.

this emerging secondary market for mortgages, in the US, were: an option to pass on the collection handling to another bank, and therefore to increase efficiency, standardization of the mortgage market (uniformed handling procedures, uniformed legal documents, etc.) and creation of a broad, detailed data base in regard to the mortgage market.

The mortgage sector demonstrates, therefore, the advantages interred in the removal of brokers from the capital market and in creation of a direct link between business firms and investors.

2.2.3 Risks of Securitizations.

Investment in asset-backed securities, just as any other investment, is subject to a financial risk. In practice, cash flow from assets might behave unpredictably, and as a result investors may loose money.

When not properly regulated, securitization is characterized by a number of unique risks that give rise to fears of damage that both parties directly involved in securitization as well as brokers might incur. Presuming that this world trend will not by pass Israel, and securitizations will become more widespread in the future, it is important to regulate this subject from an overall economic point of view.

The parties that might incur damage because of the securitization are – investors and debtors of the Originator.
First, a presentation is made in which the investors are told about total separation that exists between the Originator and the securitized assets, therefore they are not subjugated to the Originator's insolvency. In case this presentation is incorrect, the investment in bonds will be based on wrong assumptions and investors might loose money due to factors that haven't been taken into consideration.
Second, as will be detailed below, in securitization - liability of debtors is referred to an SPE. In this context a risk exists that rights of debtors, according to the agreement they have with an Originator, will be compromised as the result of reassignment. More over, even third parties might incur financial damage because of securitization; those are Originator's creditors (suppliers, lenders, etc.) and any other party that becomes affiliated with the Originator on the bases of his financial reports. The conclusion therefore is – securitization that is wrongly depicted in financial reports of the Originator might gravely mislead those who come into a business contact with him.
From the standpoint of accounting - the option to exclude assets that are subject to securitization from the Originators' balance raises fears of manipulation in regard to the accounting presentation of the Originator's assets and liabilities in his financial reports. The "**Enron Affair**" is, probably, the best known example of the potentially harmful use of securitization. American company "Enron" has created over 3,000 SPE entities that did not comply with disclosure requirements in their financial reports (off-balance sheet) while some of them were

produced for securitization purposes. In retrospect, it seems that a motive for creating all these entities was in a desire to conceal loses and to avoid registering them in financial reports, also - to artificially increase the value of the assets, to create profit, to remove loses from the balance and to increase the equity. Following the "Enron Affair" it became clear that the accounting management of the SPE entities was wrong, and that in many cases Enron had to amalgamate reports from these entities with its own reports, as well as to refer to Enron's business transactions with those entities as artificial ones, wanting any economic essence.

In the US, the "Enron Affair" brought about vigorous action on two levels.
First – the creation of federal legislation, designed to take care of issues related to the establishment of SPE entities, transactions with affiliated parties and confirmation procedures.
Second – the re-examination, broadening and updating of the accounting standardization of this issue, with emphasis on the weak points that had been exploited by Enron.
Further more; the legislative procedure to ratify the Bankruptcy Abuse Prevention and Consumer Protection Act (2001) - which was to define criteria for securitization of assets, has been suspended pending the Enron Affair.

2.3 Securitization market in Israel and Abroad.

The international securitization market is both vast and diverse, but Israel is one of those western countries that lag behind in this field. In this report we will survey major securitization markets in the world – the US and Europe, and will look at the budding Israeli market. It is worth remembering that flourishing securitization markets also exist in other countries such as Australia, Japan and so on.

2.3.1 Securitization in the United States.

(Based on the data supplied by the American Securitization Forum)

Securitization, in its present form, began in the early 70's on the American mortgage market. Active encouragement of the American government, that was interested in developing a secondary mortgage market in order to allow funding institutions that provide mortgages to improve their liquidity, brought about the creation of a number of institutions (Government National Mortgage Association, Fannie Mae & Freddie Mac) whose sole purpose was to buy mortgages from funding bodies that generated them and to transfer the rights on them to investors.
First securitization, which was carried out outside the mortgage market, took place in 1985, in the US. Sperry Corporation had securitized its future income, expected from the leasing of computer equipment.
Until the mid 90's, growth and development of the American securitization market was somewhat slow. For instance, the overall

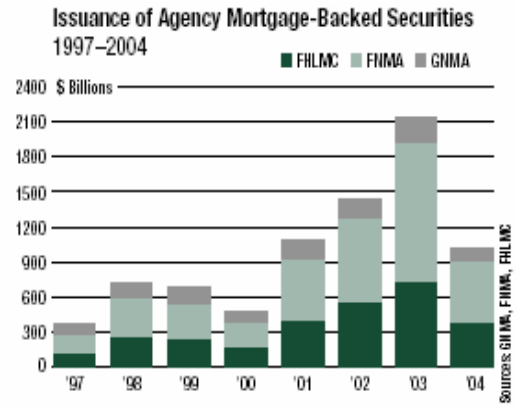
value of securitization transactions in 1985 was – 50 milliard dollars, while ten years later it stood on 250 milliard dollars. In the last decade, a sharp increase, in the volume of securitization transactions, took place on the American market, and in 2004 the scope of issuing had climbed to 2.65 trillion dollars.

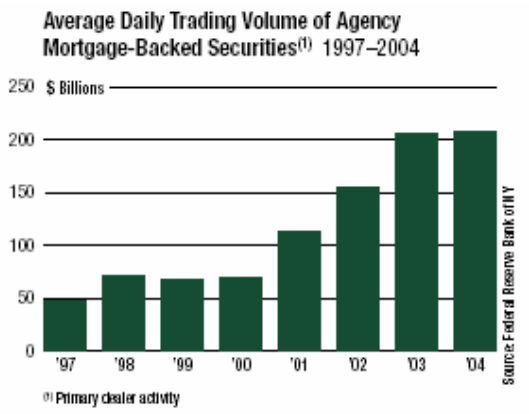
US are the largest securitization market in the world today. If we consider its scope, we will realize that this is the only securitization market in which both private and institutional participants are actively involved. The American market offers numerous implementations for securitizations that vary from one another by virtue of their characteristics, and present investors with diverse possibilities of risk and return. According to the experts' estimates, about 75% of the turnover on the world's securitization market – originates in the United States. This in itself underlines the significance of this market on a global scale. In addition to the aforesaid, a considerable number of investors in other securitization markets in the world, such as Europe and Japan - are American.

One can divide the American securitization market into two main sectors: Mortgage Backed Securities (MBS) that constitute two thirds of the market and Asset-Backed Securities (ABS).

Mortgage Backed Securitization (MBS)

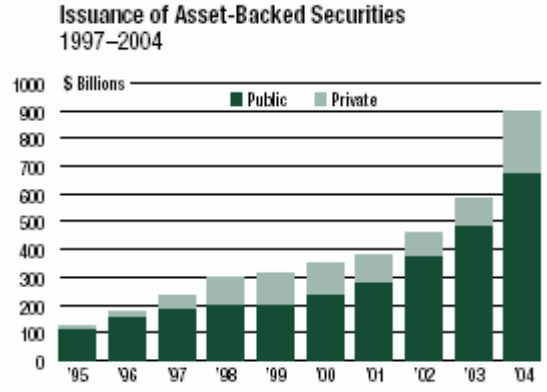
In the MBS field - the securitization is still controlled by government institutions that had pioneered securitization in the 70's. The economic back-up extended to these institutions, by the US government, had secured the confidence of investors' to such extent, that even today – 30 years after the first securitization was carried out, these three institutions still handle a notable part of all securitizations. In 2004, the Big Three had issued one trillion worth of Mortgage Backed Bonds, in contrast with 750 milliard Mortgage Backed Bonds – issued by all other institutions., Impressive though the are, these numbers represent a sharp decline – of about 43%, in the volume of bond issuing, by comparison to 2003 when it was about 3 trillion dollars. The decline of 2004 was due to stabilization of interest rates in the US that came after years of sharp decline in interest rates - years during which an unprecedented wave of securitization took place. As it stands now, the mortgage backed securitization market constitutes about two thirds of the overall securitization market in the States and the daily trade volume on this market is monumental. As may be seen from the diagram below, the daily volume of trade in mortgage backed bonds, issued by the Big Three, had risen from 40 milliard dollars – in 1996, to more than 200 milliard dollars in – 2004.

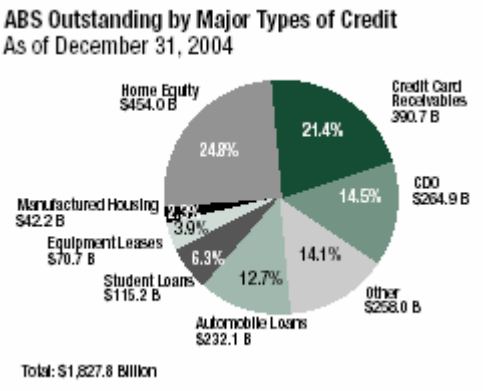




Securities backed by other assets.

The impressive growth of the American market in this field continues; the worth of asset-backed securities, issued in 2004, was around 900 milliard dollars. Examination of securitization (see diagrams) shows, that together with world wide recognized securitization of such assets as clients' income, credit cards, leasing income and CDO - the most prominent market share belongs to Home Equity Loans. These loans are given for any purpose and therefore are considered a high risk, high yield investment. In the last three years this segment of the market grew to a quarter of all the deals carried out on securitization market, and by the end of 2004 stood at 450 milliard dollars. This can be seen as an indication of change that takes place on the American securitization market, when next to the relatively safe and well-known means of securitization new and riskier investment instruments are developed, instruments that yield higher returns for those who invest in them.





2.3.2 Securitization in Europe.

Securitization market in Europe
(ESF) data Based on European Securitization Forum

The fact that US are considered a pioneer of securitization, notwithstanding, transactions of similar nature has been carried out in Denmark and Germany some time ago. Yet the European securitization market had grown mostly during the last decade due to the following

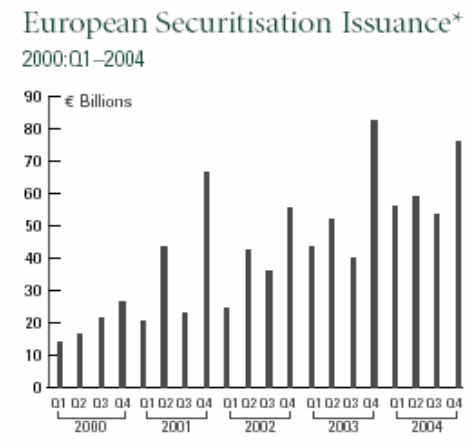
factors:

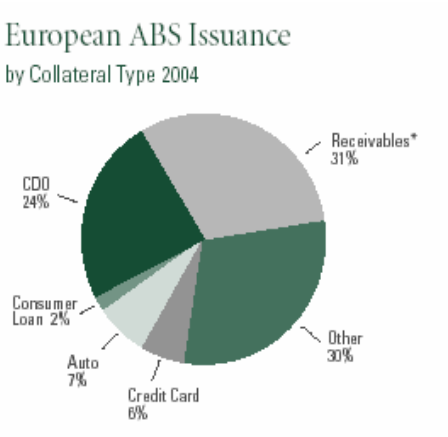
- ✓ The adoption of Euro as a uniformed currency had, almost completely, abolished the currency risk and contributed to a wider examination of investment opportunities in Europe.
- ✓ Legislative and regulatory change in procedures, which took place in many European countries, had encouraged securitization as well as legal and accounting acknowledgements necessary for its existence.
- ✓ Regulatory and competitive pressures, on financial institutions, forced them to strive for higher return on investment and caused them to direct their financial resources toward the securitization market.
- ✓ Higher standard of disclosure on the mortgage market, combined with a relatively low risk of cash flow expected of this market, had raised the credibility of securitization.
- ✓ Wider scope of securitized assets that the one available prior to the aforesaid changes excludes incomes of sport teams, incomes of funeral homes, income of banquet halls, etc. All those factors had increased the number of securitizations sharply. In the last decade (particularly in the years 1999, 2001 and 2003 – because of the adoption of Euro, legislative changes, the entry of new members, etc.), lead to a huge increase - of hundreds of percents - in transactions took place on the securitization market.

The estimation is that in 2005, securitization will reach 300 billion Euros. The table below, presents data regarding the fast development of the European securitization market:

Characteristics of the European market:

Although the European securitization market is smaller, in terms of trade volume, than the American one it is not so in regard to diversity of assets it securitizes. While in the US mortgage securitization accounts for 75% of all securitizations, in Europe many securitizations are based on other financial assets (around 40% of all securitizations). As one can see from the diagram shown below, the break down of securitizations according to securities (mortgages not included), shows that despite the fact that most securitizations are still traditional – such as CPO, clients' cash flow, loans and credit cards, 30% of all securitizations done in 2004 are of other financial assets (by comparison to only 2% in 2000).

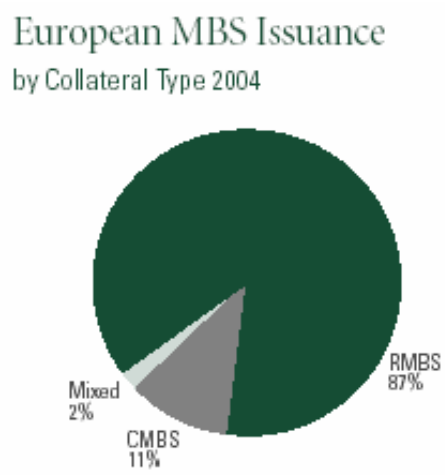


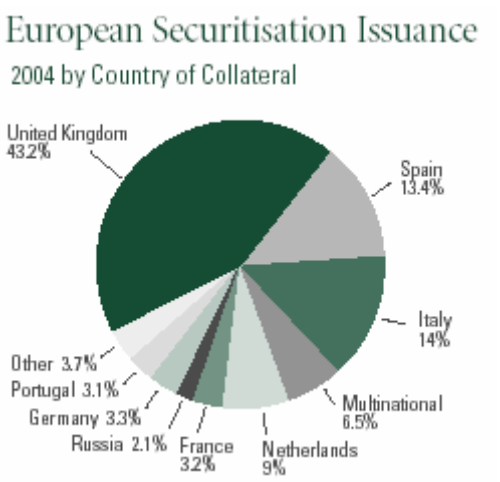


The absence of government backed institutions, such as the American Government National Mortgage Association and Fannie Mae, probably had an influence on the size of mortgage securitization market in Europe. And yet this market still accounts for 60% of an overall share of the European securitization market.

The change of legislation, in various European countries, has allowed the mortgage securitization market to grow, although, as the table below indicates – most of the easements were given to RMBS, Residential Mortgage Backed Securities. These mortgages constitute 87% of all mortgage securitizations. In the opinion of experts' a major growth area is - commercial mortgages, of which only a small fraction is securitized at present.

Until the beginning of 2000's – the European securitization market was an exclusive estate of several states (mainly Britain, France and Germany), however during the last few years many other countries have discovered that securitization is an important lever of economic growth. Today countries such as Spain, Portugal, Holland and Italy are considered securitization powers on European scale. The table below charts the distribution of the European assets' securitization according to countries (based on the positioning of the backing assets). It shows that although Britain is still a leader in European securitization, other countries are closing the gap, while countries that were leading in the past, such as France and Germany are loosing the lead.





2.3.3 Securitization in Israel

In the last few years securitization compatible transactions became more wide spread, here In Israel, although by comparison to foreign securitization we are talking about a very limited scope of transactions. All those transactions have been carried out on the private market and no bonds have been issued to the public. The buyers of these bonds were mainly institutional investors and transactions have been monitored by the Israeli Credit Rating Agencies.

Proper securitization of Israeli companies was performed in two cases.
First - Mahteshim Agan Industries Ltd., in revolving securitization of about 150 million trade receivables.
Second – Israeli Chemicals (Chemicaliim le Israel), in revolving securitization of about 250 million trade receivables.
In both cases the transactions were carried out by means of multi-seller securitization conduit and the acquisition of securities was done on the American market.

At the beginning of November 2004, the nonpayment of interest on bonds issued in a securitization compatible transaction to institutional clients by the SPC company Car and Go and backed-up by client's dept of the leasing company Splendid, was made public. The high credit rating that was given to the bonds (AA) fell dramatically (to – D), following the nonpayment. The details of this case are not yet confirmed, yet it is clear that a separation between the Originator and the SPE did not withstand the test of a crisis since the nonpayment of interest was due to the collapse of the Originator. The case of Car and Go should be seen as a warning sign in the development of the unregulated securitization market in Israel and the lack of legal and operation standards in this field.

Chapter 3
3. Accounting Aspects

3.1 Introduction.

From an accounting point of view - securitization is a transaction whereby financial assets are turned into securities (bonds, shares, etc.) Economically – securitization is a funding transaction where a Transferor/Originator gets a recompense, cash generally, against the assets he transfers. The assets are transferred to an SPE or to a number of bodies established for the purpose of a transaction and get a credit rating higher than the one a Transferor would have got. As a result financing costs of securitization are reduced for the Transferor.
Generally, we can say that any securitization can be positioned on a scale where at one end there is a purely financial transaction and on the other – a pure sales transaction.
A pure financial transaction is in essence acceptance of funding (cash against a loan) whose remuneration is secured by assets. At the moment of cash acceptance the assets are still in the Transferor's possession, he keeps carrying on all the risks and collects the returns connected to the assets (further on - "total involvement" of a Transferor).
On the other hand in a pure sales transaction, a Transferor sells his assets to a third party, and after the sale there is no further involvement with the transferred assets, on his part (he does not hold any right in those assets, does not provide any service for them, etc.)
From an accounting point of view there are essentially two basic questions in regard to securitization, that are intertwined and that the answer to them shall determine if in terms of accounting the transaction is a sales or a financing securitization. Derecognition from the Transferor's reports – is one question to be discussed, the other is - the need to merge the receiving body (to which financial assets are transferred) in the Transferor's reports.
The answer to these questions should be given by taking into consideration that a Transferor keeps a certain amount of involvement in this transaction, in different ways such as: holding on to a certain percentage of rights in transferred assets, servicing of transferred assets, recourse of assets, etc.
The measure of the Transferor's involvement, in the securitized assets, will in the end be the factor which will classify the securitization as a "sale" or as "funding", and as a result will also determine the answer to the question of Derecognition. This involvement is a derivative of the following factors:

- ✓ A measure of assets' separation from the Transferor
- ✓ A measure of control that a recipient acquires over the assets
- ✓ A measure of risk and proceeds transferred to the Recipient
- ✓ Rights that a Transferor continues to hold in transferred assets: extent of those rights and the rights they carry
- ✓ Extent of the Transferor's evolvement and liabilities in regard to transferred assets.

3.2 American Rules of Accounting

The American Standard addresses questions of derecognition of financial assets, transferred during securitization from the Transferor's reports and the

need to merge reports of the transferred entity, in a number of Standards and accompanying comments. The rules of derecognition of financial assets are stipulated under FAS 140. This Standard, in conjunction with regulations that stipulate conditions for derecognition of financial assets from the Transferor's reports, regulates specific rules - for entities receiving securitized financial assets - under which they are exempt from merger. These receiving entities are called Qualified SPE or in short QSPE.
Merger of legal entities that does not fall under the regulations of the QSPE, under FAS 140, shall be dealt with in accordance with other publications – such as ARB 5, which presents a conventional voting model whereby legal entities are merged according to majority voting rights held in them.
FIN 46R – presents a model for merger of legal entities for a special purpose enterprise (SPE), whereby voting rights have little meaning and a merger is determined according to changing rights and their main beneficiary.
FAS 140 (Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities) stipulates, among other things, accounting rules for the sale of financial assets (such as securities, clients, debt portfolio because of tenancy fraud and financial derivatives), rules for securitization (generally partial sales transactions with continuous involvement of the seller), as well as rules for the sale of liabilities. As aforesaid, the Standard does not stipulate SPE's rules of merger with the exception of the OSPE's. It is important to note that FAS 140 outlines securitization accounting rules from the Transferor's stand point only, and does not deal with accounting rules related to the recipient.

The FAS 140 model, which determines derecognition of financial assets from the Transferor's reports, is based on the judicial structure of securitization. At the root of the model is a question of the Transferor's continuous control over the assets that have been transferred, and the assumption that it is possible to separate cash flows from those financial assets into financial components. According to these assumptions the Standard stipulates that a Transferor shall include in his reports those of the financial components which are under his control, and exclude from his report – those components which he no longer controls.

Sale of financial assets will be made possible only if a Transferor does not control the transferred asset any longer and had received in return for the transfer recompense that does not include any privileges in the transferred asset. In this case the Transferor will be perceived as someone who lost control over the asset, if all of the following conditions are fulfilled:

- **1**. The transferred asset has been separated from the other assets of the Transferor – meaning the transferred asset is out of reach for the Transferor and his creditors, including a case of bankruptcy or receivership of the Transferor. This provision is checked by analyzing the judicial structure, usually supported by a judicial opinion that testifies to the effect of "True sale at law".
  These are the bounds within which the question of a "true sale" is examined in order to establish if the assets have been transferred from the Transferor to the SPE.
- **2**. The asset's holder may act as an owner in respect to the asset,

meaning – the recipient of the asset (or in case the recipient is a QSPE - privilege holders) has a right to mortgage, sell or exchange the assets.

- **3**. The Transferor does not effectively control the assets, either by means of an agreement that obliges him to buy or redeem them prior to their remuneration date, or by means of capability impartation on the part of the Transferor to cause the Holder to return him some specific assets. For example – by means of an agreement that allows and binds the Transferor to buy back or to redeem the asset prior to its remuneration date, or gives the Transferor the means to commit the Holder to return to him the transferred asset.

In case the conditions of the sale are not fulfilled - securitization will be seen as a financing deal, guaranteed by the transferred financial assets. No loss or profit related to the deal will be recognized and the assets that have been transferred will be presented in the Transferor's financial reports (those assets will be identified as restricted to redemption of ascribed liabilities only).
In case the conditions of the sale are fulfilled – the Transferor shall derecognize the asset he transfers from his reports, and recognize the assets and the liabilities that have been received (cash, rights, derivates and other liabilities) as return on those assets, in accordance with their fair value, he will also recognize any loss or profit incurred as the result of the sale.

An interesting question that originates from the recognition of loss or profit in securitization arises in light of the assumption that FAS 140 allows separation of financial assets into financial components and a sale of only a certain part of financial asset. In this case regulations under FAS 140, stipulate that the Transferor shall include the non-transferred part of the asset in his books according to cost. This cost shall be determined by dividing the overall cost of assets between the part which was sold and the remaining part, according to the relative fair value of each part at the time of sale. The profit that will be recognized on behalf of the part that was sold shall be calculated as a differential between the recompense received and the value of sold assets. In calculating the consideration - assets and liabilities (which have been registered in the Transferor's reports on the bases of their fair value on the date of sale) will be taken into account.

The question, of merging the Recipient's reports with the Transferor's reports, is a sensitive and complex one. Various cases have brought about new thinking regarding merger rules of entities for special enterprises and to the publication of a number of guiding instructions on the subject.

As aforesaid, FAS 140 presents a model of entity eligible for special purpose – called QSPE, and that complies with all the meticulous regulations listed below. By complying with all the regulations a special entity shall not be merged into the Transferor's books. In case a receiving entity does not comply with Standard requirements of QSPE, its merger will be taken care off by means of renewed clarification 46 (Fin 46R), published in December 2003. It presents a complex model designed to check what rights are held by various parties in an SPE and who the Primary Beneficiary is; who will be the one to

merge the entity in his reports.
Publication of the renewed clarification 46 – with all its complexity – gave rise to high motivation, in many companies, to pass the requirements to be purchased by a QSPE in order not to comply with merger requirements. Following this development, the FASB (American Standards Board) has decided to issue an amendment to Standard 140 that toughens the QSPE requirements and tries to ensure that entities which are suppose to be included in the Transferor's financial reports will not be derecognized.

For the purposes of FAS 140 – QSPE is a Legal Vehicle that complies with compilation of the following regulations:

1. QSPE – is totally separate from the Transferor.
2. It is entitled to carry out the following activities:
- **a.** limited activities only that,
- **b.** are explicitly formulated in the incorporating documents of the entity.
- **c.** These activities are subject to a major change only by majority agreement of most rights holders in the entity, which are not a Transferor, his affiliates or agents.

3. It is entitled to hold
- **a.** Passive financial assets which do not bestow voting rights, nor partaking in the decision process.
- **b.** derivative financial instruments related to the rights issued by the entity to whoever is not a Transferor, his affiliates or agent.
- **c.** financial assets (such as: guarantees or rights to securities) that will render the QSPE with compensation, in case other entities appointed to manage the assets that were transferred to QSPE or assets that it is entitled to according to its establishment agreement, had failed to do so.
- **d.** service rights related to financial assets held by the entity.
- **e.** non-financial assets in temporary possession associated with the collection of financial assets that are in its possession.
- **f.** cash collected from assets held by the entity and investments which were acquired by means of cash held according to its division among rights holder participating in the entity.

4. The entity will be allowed to sell or dispose of financial assets (which are not cash), only as an automatic reaction to one of the following instances:
- **a.** control of an event or under the following circumstances:
  - (1) the event is explicitly indicated in the incorporation documents of the entity;
  - (2) the event or the circumstances are not under the control of a Transferor, his affiliates or his agents;
  - (3) the event influences or might influence a drop in fair value of financial assets to a rate below the fair value of assets on the date they were received by the entity.
- **b.** privilege realization of BIH (beneficial interests' holders) which own the entity and are not the Transferor, his affiliates or his agents, to return beneficial rights to the entity.
- **c.** options realization by the Transferor, CALL or ROAP (removal-of-

accounts-provision), interred in founding documents of the entity, transfer of assets to the entity or receiving beneficial rights in the transferred assets.

d. dismantling the entity or its reaching the redemption date, fixed on the date of the rights issuing in the entity.

As aforesaid, suggestion for amendment to Standard FAS 140 was published regarding a body's suitability to act as QSPE and regarding separation of the transferred assets. The proposal was meant to accomplish two goals:

1. To bring about consolidation of assets which were transferred by Transferors that can acquire effective control of the transferred assets, in case they provide financial support to the entity

2. To ensure that a particular body will remain within the FIN 46 regulations (will not be considered as an QSPE) if a Transferor is capable of increasing or protect the value of his inferior privileges, by means of financial support or by means of decision making in regard to the issuing of additional rights in this entity.

Adoption of this amendment may have the following consequences:

1. An entity shall not be considered a QSPE in case it is bound to a Transferor by an agreement committing him to money or asset transfer for the purpose of supporting the entity's liabilities toward the rights holders.

2. Commitment to use a two-stage structure in order to achieve separation of transferred assets, when the second entity is a QSPE, if the transfer is against the issuing of rights in this entity.

3.3 International Accounting Regulations.

International Standards, much like the American ones, are dealing with two main securitization questions – derecognition of assets from the Transferor's report and the need to merge the receiving entity.

Rules that relate to derecognition of assets from the Transferor's financial reports are interred in the International Standard 39 (ISA 39), under **Financial Instruments: recognition and measurement,** which were published in December 2003 with the effective date in January 2005. Merger regulations for companies and corporations are stipulated under the International Standard 27 that deals with controlling mergers (compatible with American Standards ARB 51 and FAS 94) in clarification no.12 (SIC 12). SIC 12 deals specifically with merger of entities for special enterprises (SPE) in the Transferor's reports (compatible with American Standard FIN 46).

The International Standard, in regard to derecognition of financial assets from the Transferor's financial reports, is based on the International Accounting Standard no.39 that generally adopts the American Model which integrates control and financial components. Yet the International Standard concentrates its attention on the economic essence transactions and not on their judicial form, it contains general regulations which require serious consideration. The

International Standard differs from the American Standard by putting less stress on judicial analysis of the transaction and on the need to have a legal opinion regarding the status of the transferred assets in case of bankruptcy or receivership of the Transferor.

According to the International Standard, financial assets – in whole or in part – shall not be merged into the Transferor's reports, in case the transferor looses contractual rights resulting from these assets.
The decision, on whether the Transferor will loose control over the transferred assets, shall be based on the examination of both the Transferor's and the Recipient's situation after the transfer is completed. In case the Transferor did not loose control over the assets after their transaction, he should keep reporting on these assets in his financial reports; in this case the transaction will be seen as a funding deal, secured by the aforesaid assets. The Standard lists a number of examples where a Transferor did not transfer control over the assets (particularly – where a Transferor keeps on carrying the risks in regard to those assets).

The valid and updated International Standard, for the reporting period beginning on January 1, 2005, is based on the perception that derecognition of assets must be based at first on the transfer of risks and income, and at the second stage the matter of control over the transferred assets should be examined. According to the updated International Standard – at first, all subsidiaries and the SPE have to be merged (in accordance with regulations under sections IAS 27 and SIC 12) and then, on the bases of the merger, the decision should be made as to whether the derecognition of transferred assets from the Transferor's financial reports should take place.

By contrast to the American Standard, the International Standard does not recognize the concept of an SPE that under certain conditions will never merge with the reports of the Transferor (by comparison to QSPE – that appears in the American Standard). It also does not stipulate requirements for legal separation of the transferred assets, as in the American Standard, and does not promise that the creditors of the Transferor will not be able to put their hands on the transferred assets even in case of the Transferor's bankruptcy.

The rules for an SPE merger are stipulated under clarification SIC 12 of the International Standard, which stipulate that an SPE shall be merged in the Sponsor's reports in case:

- ✓ The activity of an SPE is carried out for the Sponsor;
- ✓ The Sponsor controls the decisions made at the SPE, in order to get most of the benefits from the SPE;
- ✓ The Sponsor holds most of the risks and/or proceeds of the SPE activities;
- ✓ The Sponsor holds most of the financial residual rights of the SPE assets.

The revised International Standard recognizes three options for the transfer of financial assets:

1 The transferor has transferred all substantial risks and returns

affiliated with the financial asset. In this case the Transferor will derecognize the financial asset from his financial reports. The transfer of all substantial risks and returns affiliated with financial asset takes place when one of the following conditions occurs:

a) Contractual rights for cash flow generated by financial assets have expired.

b) Contractual rights for cash flow generated by financial assets have been transferred.

c) The Transferor retains contractual rights for receiving cash flow from a financial asset, however he is contractually obliged to pass on this cash flow and all risks and proceeds, from this asset, to one or more receivers, also all of the following conditions have to transpire:

- ✓ The Transferor is not obliged to pay sums of money to receivers, with one exception, where by he collects sums of money from the aforesaid asset.
- ✓ The Transferor is prohibited to sell or mortgage the aforesaid asset, with the exception of turning it into collateral for receivers, in order to fulfill his liability to pay them cash flows that will be collected.
- ✓ The Transferor is obliged to transfer all cash flow sums that he collects on behalf of receivers without substantial delay.

2. Transferor has retained all substantial risks and returns related to the financial asset. In this case the asset will remain in his financial Reports.

3. The Transferor does not retain, but neither does he transfers, all substantial risks and returns related to the asset. In this case Transferor's level of control in the transferred asset has to be checked. If control over the asset has been transferred (meaning – the corporation doesn't retain Continuing Involvement in the asset), the financial asset can be derecognized; however if a corporation has retained Continuing Involvement in the financial asset the Transferor will continue to report the asset up to the level of his continuing involvement. The level of involvement will be determined according to the level of the Transferor's exposure to the changes in the value of the financial asset and its expected cash flow.

Regarding the matter of gain and loss recognition, from derecognition of financial assets under securitization, the revised International Standard determines – in case of derecognition of financial assets from the Transferor's financial reports the recognition of gain and loss will be made at the time of the asset's derecognition from the reports. The difference between the income received and the value on the books of the asset is recognized as gain or loss in the periodic gain/loss report. A new asset or a new liability created on the time of sale, as well as a liability to provide future services, are recognized at the time of sale according to their fair value.

Regarding the possibility of the Transferor to act as Servicer of the assets, as

part of the securitization, the Standard stipulates - if a corporation transfers a financial asset under the conditions recognized as sale, and as part of the deal the corporation retains the right to Service the transferred assets for a service commission, it has to acknowledge the asset or the service commitment pertaining its service rights, at the time of sale.
If it is foreseeable that the commission for services rendered by a corporation will not compensate this corporation sufficiently, for these services, the corporation shall recognize its liabilities regarding the service on the basis of its fair value. If the foreseeable commission that will be received by a corporation will provide it with higher than fair compensation for the services rendered, the corporation must see it as an asset derived from services rendered, (the value of the asset will be determined by value appropriation in the books of the transferred asset, according to the fair price value of the transferred and of the remaining part).

Classic securitization (sale of assets to an SPE) might encounter the following difficulties, which will prevent derecognition of assets in accordance with International Standard:

1. There won't be a pass-through test of cash flow rights outside the reporting group, since according to SIC 12 regulations - generally the SPE will be amalgamated, and therefore in order for securitization to be recognized as "sale" a pass-through test must take place. It is worth noting that only a small number of securitizations is designed in a way that complies with these conditions.
2. Even in a case in which securitization does carry out a pass-through test; there is a low likelihood of all substantial risks and returns interred in the asset being transferred to an SPE. For example, the cushioning provided by the Transferor as part of the classic securitization, customary in Israel, is such that as part of it not all substantial risks and returns interred in the asset are transferred to the SPE.
3. In conclusion, by assuming that a Transferor does not retain all substantial risks, generally a test of control will not take place since an SPE can not sell the financial assets.

3.4 The existing situation in Israel and Committees recommendations.

The securitization market in Israel is still in its infancy; therefore securitization cases carried out by the Israeli companies are few and far between. Those few that have been carried out were based on the American Standard – FAS 140.

On the other hand, in the past, the Israeli Accounting Standards Board had made a strategic decision to match Israeli accounting regulations to international ones – issued by the IASB (International Accounting Standards Board). The decision was made on the premises that in the age of globalization, Israel can not use a "local business language" and it has to act in accordance with the international accounting standards.
In other words, if the Israeli accounting system will differ from the

international one, it will act both as an "entry " and "exit barrier" for foreign investors, and at least to some extent as a barrier for the Israeli firms wishing to be traded on international markets.

In line with this decision, and as a result of the Committee's deliberations, the Israeli Accounting Standards Board has published in July 2004 an amendment to Standard 23, which is based in part on the IASB no.39 that regulates derecognition of financial assets.

In light of the decision made by the Israeli Accounting Standards Board, that it is necessary to aspire to the adoption of the IASB standards in Israel, as many other developed states have already done, it seems reasonable to adopt these standards in regard to securitizations as well. It is important that transition to the IASB standards will be carried out in full and without any deviations, since any small deviation will make it impossible for the financial reports issued in Israel to be presented as reports prepared according to the International Standard.

The Committee is aware of the difficulties that arise from the immediate adoption of Standard proposal:

1. Immediate adoption of the International Standard, that stipulates stringent requirements which have to be followed in order to recognize derecognition of financial assets from the amalgamated financial reports, might prevent the development of securitization market in Israel even before it made its first steps.
2. The practice customary in Israel, even though it is based on a small number of securitizations, is fundamentally different from the International Standard; it is based on control tests in transferred assets, relies upon legal opinion – all in accordance with the American Standard.
3. The New International Standard has not yet come into effect, worldwide, and there is no accumulated experience in regard to its enactment, in many spheres strong criticism is raised regarding the Standard's regulations.

In light of the above stated facts, the Committee has decided to adopt the recommendation of the Israeli Accounting Standards Board that postpones the implementation of Standard 23, based on the renewed Standard 39, till 2007 at least, in order to allow the securitization market to grow and adjust itself to the stringent requirement of the International Standard. At the same time the learning process, based on the experience acquired from the application of Standard 39 worldwide, will continue.

In the interim period, before the implementation of the proposed Standard, all securitizations will be carried out under the American Standard FAS 140, since at present it is the customary practice in Israel.

The Committee adopts the recommendations included in the draft proposal to the Accounting Standard 23, according to which the Standard will be applied, in the manner of – from now onward, to financial reports for the period starting

on January 1, 2007. Accordingly, if an institution had derecognized financial assets in accordance with the accounting standard customary before the implementation of this Standard, as a result of securitization carried out prior to January 1, 2007, and those assets would not have been derecognized according to this new Standard, the institution shall not recognize these assets anew.

Nevertheless, the act of sweeping adoption of the International Standard in Israel, as planned by the Israeli Accounting Standards Board, from 2008 will require new thinking in regard to the transitional regulations. It is worth noting that transitional regulations to the International Standard 39 state, that if assets have been derecognized from the balance according to prior existing accounting regulations they will not be recognized anew in financial reports, even if according to International Standard 39 those assets would not have been derecognized.

In light of the fact that there is no specific international standard for dealing with accounting aspects of securitization from the receiver's (SPE) point of view, while at the same time taking into consideration the fact that a receiver is also an issuer of bonds to the public, the Committee proposes to formulate clear rules regarding the reporting and disclosure of assets which have been transferred to the SPE.

Chapter 4

4. Legal Aspects

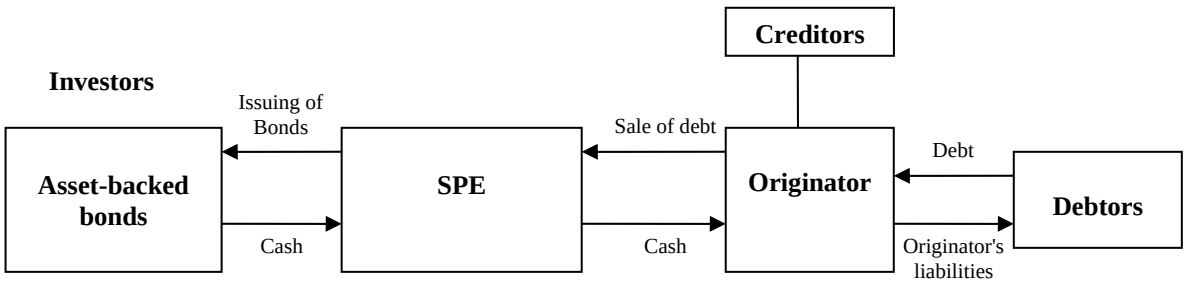
4.1 Protected rights and legal issues of securitizations.

Judicial certainty is a prerequisite for the existence of a regulated securitization market. The lack of binding legislation or adjudication on this subject in Israel is a major hindrance to the development of the aforesaid market.
In this sense Israel is lagging behind many countries, which have regulated the legal aspects of securitization in a special legislation. Those countries include France (1988), Spain (1998), Italy (1999), Greece (2003) and South Africa (regulations from 2004). In other countries, where special securitization legislation does not exist, such as England and the US, there is a judicial infrastructure in place that allows complex securitizations to be carried out, making separate legislation less urgent.
Nevertheless, even in the US – the birthplace of securitization, voices are being raised in favor of securitization regularization by means of the Federal Law and there are also some examples of State level securitization legislation.[16]

[16] In the US amendments have been made to State Laws, in order to separate the securitized assets from other assets of the Originator: for example, see - Delaware Uniform Commercial Code, Chapter 27A. Assets Backed Securities Facilitation Act (74 Del. Laws, c. 332). Initiative for federal legislation of a law to amend the American Bankruptcy Code didn't succeed. Bankruptcy Reform Act of 2001, Section 912 of H.R. 933,

Special Securitization legislation is necessary not only for its obvious encouragement of the securitization market, but mainly for the regularization of protected rights, those of the parties involved. The Securitization Law has to balance the rights of three groups:

- ✓ **Rights of investors** in the SPE bonds, to ensure that the rights transferred to them are out of reach for the Originator's creditors, in case of the Originator's bankruptcy.
- ✓ **Rights of the Originator's creditors,** both in present and in the future, as well as to prevent ferreting of the Originator's assets by means of securitization, and to ensure the rights of creditors to a full and precise picture of the state of the Originator's assets and liabilities that reflects the securitizations he has carried out.
- ✓ **Rights of the Originator's debtor's**, so that they will not be compromised as a result of the securitization due to their affiliation with the Originator, as well as to extend protection onto their rights.



In Israel, there is no specific judicial regularization regarding securitization; the fact which is a serious barrier to the development of the regulated securitization market.
Securitizations that do take place are accompanied by a great transaction of judicial uncertainty, and the rights of the parties evolved might get compromised as a result.
The Committee is of the opinion that a proper way to rectify this situation is by means of additional legislation to the Securities Law. One Law will regulate all aspects of securitization; we must avoid individual amendments to various existing laws, which transaction with individual aspects of securitization, as much as possible.
In this chapter we will review the main problems debated by the Committee regarding general judicial problems of securitization, as well as the ways to solve them.

4.2 Transfer of rights

4.2.1 General

Securitization is a transaction whereby the rights of a debtor (the Originator) toward a certain party are transferred to a third party (the SPE). The Israeli law that regulates the issue of transfer of rights is - Transfer of Obligations Law, 1969 (hereby - Transfer of Obligations Law). In a regular transfer of rights there are two elements – exchange of creditors and transfer of privilege ownership. The original debtor, the Transferor, ceases to be the creditor of the debtor and a third party, the Receiver, becomes for all means and purposes a debtor's creditor. In addition, the

contractual right ceases to be an asset of the Transferor and becomes a Receiver's asset. [17]

4.2.2 Debtor's rights.

Transfer on the Originator's rights to an SPE raises complex questions regarding the debtors' status, their rights, and the relationship between the Originator and the SPE. We will discuss these questions on two levels – rights of debtors' at the time of transfer, and their rights after the transfer.

A. **Rights of debtors' at the time of transfer.**

Paragraph 1(a) of the Transfer of Obligations Law, stipulates that the right of creditor is transferable without the debtor's consent, except for cases where this right has been limited according to the law, according to the substance of right, or according to the agreement between the debtor and the creditor. The protection of the debtor is therefore achieved by conditioning the transfer by his agreement, or by the stipulation of the law according to which the transfer does not change the terms of rights and therefore the debtor is entitled to raise the same claims against the Receiver as he was able to raise against the Transferor.[18] In light of the aforesaid, under regular circumstances, the Originator is not required to request agreement from the debtors or to inform them regarding the transfer to an SPE.[19] Announcement to the debtors benefits the SPE (the Receiver), since the claims of debtors are limited to the claims they had at the time they have learned of the transfer.[20]

B. **Rights of debtors' after the transfer**

As aforesaid, transfer of rights – means the right is transferred as is, with all conditions attached. The debtor is not entitled to choose a Receiver or to prevent the transfer, but he has a right to claim the same claims against the Receiver as he was able to claim against the Transferor, at the time he has learned of the transfer. The claims may originate from contractual right that existed between the debtor and the Transferor, when the rights of the former have been transferred, as well as there might be external claims related to the contract.[21] For example, let's assume that a debtor has acquired an asset from **A**; **A** in turn has transferred his right for remuneration, due to him according to the contract – to **B**. In case there was an obligation by **A** toward the debtor that was not fulfilled, according to the contract, it is possible for the debtor to abstain form the payment of his debt, or alternatively, to off set his liabilities one against the other. Moreover, even if there are other connections between the debtor

[17] see Lerner, Transfer of Obligations, **Obligations law – general** (edited by Friedman, 1994), 23-29 (henceforth – **Lerner**)
[18] Paragraph 2(a) of the Transfer of Obligations Law; p. 129
[19] This condition does not exist , for instance, when there is a specific ruling against it.
[20] Paragraph 2(a) of the Transfer of Obligations Law
[21] There is a need to separate between the two types of claims: claims that originate from contractual obligations have no limitations in relation to the Receiver, regardless of when the transfer came to the attention of the debtor or weather he agreed to it or not; claims – from outside the contract can be raised against the Receiver only until the debtor became aware of the transfer. 357/00 Joshua Bockholt, judgment 529(4), paragraph 7 of the sentence.

and **A**, that are not related to the contract according to which the rights have been transferred, the debtor may raise a defending claim against his dept toward **B**.

Those possible claims, against the Transferor negatively affect the securitization period, since they mean that until the Originator fulfills his liabilities if full, toward his debtors, the latter will not be obliged to pay the SPE. As a result, a non-debiting of the Originator's debt for reasons of insolvency or for other reasons endangers the expected cash flow to the SPE's bond holders, and the severance between the transferred rights and the Originator, which is the base of the securitization, comes under question.

A practical solution to this problem might be in a clearly stipulated agreement, between the debtor and the Transferor, according to which the debtor waves off his right to raise claims against the Receiver. With that, even if there is no reason to explicitly stipulate the regulations under paragraph 2(a) of the Obligations Law, this in itself will not act as exemption from claims under other laws.[22] Also it is doubtful that this kind of approach is compatible with desirable public policy, which is aimed at the protection of consumer rights, protection that includes all consumers in general.[23]
The Committee is of opinion that this problem must be resolved under the Securitization Law, and not in a public discussion, by preserving the balance between the protection of debtors' rights and the protection of investor's (in the SPE bonds) rights as well as by the encouragement of further securitization on the capital market. Exceptions to the rights of debtors may be stipulated regarding securitizations defined by the following characteristics:

- **a.** The securitization is that of financial assets, which means – the right to receive money on a certain pre-defined date that is not conditioned by or related to the Originator's liabilities, with the exception of marginal debit (such as non essential debits related to debt collection).
- **b.** The securitization defines a mechanism for marginal debt collection, as aforesaid in advance, by the Servicer appointed by the SPE, who has signed a written agreement to take the place of the Originator if the need arises. In some cases there is a need to limit the identity of the Servicer for reasons of consumer protection. For example, when the Originator is a bank that securitizes clients' debts, the Servicer should also be a bank.

In addition to the aforesaid, there is a need to clarify that if the debtor was debited in full he will not be able to avoid paying the debt only because the identity of the one who carries out the debiting has changed.

4.2.3 Accompanying rights

Paragraph 5, of the Transfer of Obligations Law, stipulates that subject to the stipulations of the Transfer Agreement, the transfer of rights will also include any guaranty and lien given for its security, as well as any other accompanying right, to the aforesaid rights, to a degree they are given to transfer. In accordance with the

[22] See the Consumer Protection Law – 1981; Standard Contracts Law – 1982.
[23] See **Lerner**, remark 12, p. 133-132

Receiver's requirement, the creditor shall take all steps necessary to ensure that the transfer of rights is valid for any purpose.

There is a problem regarding accompanying rights that requires authorization, it relates mainly to the accompanying rights in real estate. Entities that wish to securitize loans backed by mortgage agreements, had pointed out to the Committee that change of registration on every one of the loans' remuneration securities, creates a heavy burden, the costs and complexity of which overweight the advantages of securitization.

The array of banks' securities backing the loans for purchasing an apartment include: mortgage or a warning note registered at the Land Registry Bureau, loan commitment with the mortgage registrar in bank's favor, lien registration of loan's contractual rights with the mortgage registrar, a mortgage company or in the developer's registrar.

In the Arrangements Law of the State Economy (legislative amendments for the attainment of budget and economic policy goals for the 2003 financial year), -2003 (henceforth the Arrangements Law), an attempt was made to facilitate the creation of the mortgage securitization market and the decision was – that for the purpose of mortgage and warning note (registered at the Land Registry Bureau) transfer there is no need for a separate examination of each and every loan contract; a lawyer's expert opinion, which states that the transfer of rights is possible – is sufficient for securitization purposes.

This arrangement is partial in nature and its usefulness is limited, since it does not transaction with other securities (that are not registered with the Land Registry Bureau), and does not reduce the cost of securitization, as far as the transfer of thousands of other securities is concerned. This problem might be solved in two ways:

a. By stipulating that the transfer of securities, which are accompanying rights to the loans, does not require registration; or it requires an alternative registration that will be easier and simple to carry out (for example, registration with the Registrar of Companies, or the establishment of a new, alternative, entity for registration of the securitized mortgages). We, on our part, support the claim that transfer of securities does not require registration since the purpose of the registration is to notify the property owner as well as third parties of the existence of securities which impart a particular creditor with priority rights to the property. Therefore the anonymity of the creditor, in contrast to the lack of knowledge regarding the very existence of the securities, does not impinge the rights of a property owner or third parties, and therefore does not require registration. On the other hand the stipulation that there is no requirement for registration impinges the essence of registration designed to reveal various property owners, and undermines its credibility. The establishment of a central registry for the registration of securitizations may help solve this problem.

b. By reducing the high registration costs and by shortening the process itself.

Regulation of registration - is the responsibility of the Justice Ministry, and at present it is checking the options in order to resolve the problem. We would like to underline

that the problem of registration is an acute one, it prevents the creation of the mortgage securitization market in Israel, and therefore it is well worth our while to invest an effort in order to solve it.

4.2.4 Transfer of future rights

Paragraph 1 of the Transfer of Obligations Law stipulates that it is possible to transfer the rights of creditors, including a conditional or a future right, with the exception of cases where it was negated or limited by law, according to the essence of the right or according to the agreement between the debtor and the creditor. Generally, in Israel, written decisions in various judicial contexts differentiate between the "future right" whose future materialization is certain, weather at a fixed date or weather following an event the occurrence of which is not in doubt, and between the right that has not yet crystallized. In regard to transfer of debt, what might be deduced from various judicial decisions on the subject[24] is that it is not possible to sell future debt when the transaction that will create it is yet to be consolidated.
The worldwide experience teaches us that in Revolving Securitizations future debts, whose existence has yet to be consolidated under a contract, an agreement or other legally binding way, are sold. In light of the aforesaid, the question arises – is it possible to carry out securitization in Israel in accordance with the existing law. In the **Alony** decision[25] the Supreme Court has debated the question weather it is possible to impose a requisition on a right that has yet to be formed. The Judge Proktziya has explained what the reasons for financial limitations under the law are, in regard to carrying out transactions in future assets, as follows:

"General resentment for transactions in future assets is based, mainly, on a mixed desire to protect both the debtor and the creditor. Regarding the debtor the apprehension is - that there is difficulty in estimating ahead of time, the nature of transactions and the scope of securities in future assets, as well as the apprehension to impinge the rights of a debtor, if transactions in his future assets will be sealed ahead of time, for the benefit of his creditors, without leaving him with sufficient number of free assets as required for his minimal welfare. In regard to the creditors, the apprehension is that third parties might get hurt by relaying on assets held by the debtor as securities without being aware that others have bought rights in them before their crystallization (Lerner, there, p. 77)."

As appose to these considerations, other arguments have been raised.
In regard to a debtor – the ability to extend securities onto future assets provides him with a powerful instrument for credit acquisition as well as with a possible advantage derived from it, particularly on a business level, which overweighs apprehension rooted in future uncertainty.

[24] 263/70 **Export Bank ltd. vs. Bank Leumi ltd**, decision Y(2) 672; 717/89 **Bank Igud ltd vs. Eran Tours ltd** (**under liquidation**) decision 49(1) 114, also see Zamir, **Sales Law** – 1968 (within the framework of the interpretation of the Contracts Law edited by Tadesky) – 1987, 92, which reads that it is impossible to transfer an asset that does not exist at the time of signing a contract,; **Lerner** note 12 p. 74 and on.
[25] 3553/00 **Alony vs. Zand Tal Miscellaneous Foundation ltd**. 577(3) (henceforth the Alony decision).

As to a possible damage to creditors – it is blunted by providing a registrar where it will be possible to register securities or other transactions, which the debtor carries out in future rights in a way that might expose them to potential creditors.
Therefore, the opposition to transactions in future expectations is rooted in both theoretical and practical considerations."

After this review of both the Foreign and Israeli law, in regard to transactions in futures, including the field of transfer of rights, Judge Proktziya had summarized it all in a statement that "the rule that forbids, carrying out transactions as well as extending securities to future rights (that are yet to be crystallized), stands up to a renewed scrutiny, today. Today written decisions, in Israel, have deviated from the aforesaid principal particularly in areas where legal recognition is required for financial risk or opportunity, and in instances where there is a certain probability that these future rights will come to realization. The evolution of the subject, on ways to widen judicial recognition in the means to anticipate the worth of future rights, is also reflected in decisions written in other countries. This strengthens the need and the possibilities to widen the recognition in the legitimacy of these means, if only in areas were financial and business necessities require it."[26]

In financial terms, there is no reason to differentiate between revolving securitization and securitization of contractual rights, since it is possible for an existing contract to be of a lower financial value than an expected or future chance, which might produce considerable future benefits.[27] Such securitizations are recognized worldwide and are necessary for economic sophistication.

Nevertheless, in light of the aforesaid, it is necessary to examine ways to protect both the creditors' and debtors' rights in case of a revolving securitization. The protection of debtors' rights is of great importance since we are taking about a company that securitizes future rights, and not about a single individual, whose basic welfare might be endangered. The protection of creditors' rights is of importance too, but they might be protected by way of registration, which will notify the creditors' of the Originator regarding his liability[28] and by means of proper accounting presentation. Paragraph 97, of the Bankruptcy Ordinance (new version) -1980 (henceforth - Bankruptcy Ordinance), transactions with the validity of rights transfer by whomever was declared bankrupt after the transfer. The paragraph's stipulation also applies to liquidation of a company, under paragraph 356 of the Companies Ordinance[29], and therefore it is relevant in our case.

It seems that under paragraph 97 of the Bankruptcy Ordinance, the obligation to register the transfer of future rights in revolving securitization will be applicable, since it is a general transfer of rights that does not detail contracts or names of debtors, which are part of the transfer. The purpose of this Ordinance is to supply the debtors' of the Transferor with precise information regarding his rights, so they will be

[26] See **there**, paragraph 13 of the Judge Proktziya's decision.
[27] See **there**, paragraph 13 of the Judge Proktziya's decision.
[28] Compare to the **Alony** decision, where it was decided to register the foreclosure in the books of the relevant authority that overseas by force of the Goods and Services Supervision Act (milk production) – 1967.
[29] Paragraph 356 of Companies Ordinance stipulates: "in a bankruptcy case where the rights transfer is not valid, there is also no validity to the rights of company liquidation; therefore the liquidation will come before the application of request for bankruptcy".

able to estimate his ability to repay debts and to plan their action accordingly,[30] therefore registration of the general transfer will be sufficient to protect the debtors. Since the Originator is a corporation, the registration of transfer will be done at the Registrar of Companies according to Company Ordinance (transfer of rights procedure) – 1970.
There are two recommendations made by the Committee on this subject:

a. The Securitization Law has to include a stipulation that allows transfer of future rights, if they have been properly registered.
b. The Committee is of opinion that even without the aforesaid ordinance; the proper interpretation of the existing law is that there is no obstacle for the transfer of future rights under securitization. Generally, the transfer will have to be registered with the Registrar of Companies, in accordance with Companies Ordinance (transfer of rights regulations) – 1970. Also, the transfer has to be clearly reported in financial reports of the Transferor.

4.3 Judicial Structure of the SPE and Rating of Securities Issued by it.

The structure of an SPE is determined according to judicial, accounting and tax considerations. Since there are no obligatory regulations under the law, regarding the incorporation of an SPE, the main consideration is **–** the removal of bankruptcy threat**,** meaning prevention of the SPE's assets seizure in case of the Originator's bankruptcy.

What becomes clear from the study of the foreign law is that, generally, there is no regularization of SPE incorporation, although sometimes limitations are imposed on the SPE to wear a particular legal hat; it might be a company, a trusteeship or a partnership. The main concern regarding investor protection, in the US, is that an SPE might go into a voluntary bankruptcy; therefore it is generally incorporated as a company or a trusteeship. The advantage of being incorporated as a company stems from the relative flexibility of means that allow removing the aforesaid danger, such as appointment of an independent board of directors, on behalf of the bonds holders, that will hold a right of veto in regard to filing for bankruptcy, or the introduction of safeguarding regulations into the company's codex regarding the aforesaid request. Also, in the US, there is a relative certainty regarding the bankruptcy laws, as far as companies are concerned. The use of trusteeships is usually due to the regulations, under the American Bankruptcy Code, which stipulate that not every trusteeship can appear as debtor in bankruptcy procedures.[31]

In England the requirements for an SPE creation also stem from the bankruptcy law. A new SPE company is usually incorporated in accordance with the English law or according to another law that encompasses similar rules regarding bankruptcy. The company does not carry out any other functions except for securitization, and does not employ employees.
A similar requirement might also be part of the law. For example, the Italian Securitization Law does not stipulate a particular way of incorporation, but limits the company to securitization activities only.

[30] 5578/98 Nadav Sergovy, decision 459(2), paragraph 6 written by Judge Shemgar.
[31] According to paragraph 109(a) of the Bankruptcy Code, only whoever is defined as a "person" may be sued under the bankruptcy law, this definition indirectly includes only the "business trust". From here it seems that all other trusteeships can not appear as debtors in bankruptcy procedures.

The French Securitization Law presents a different model. The Law creates a special mechanism for debt purchase, named FCC (*Fonds Communs de Creances*). This mechanism is created by means of cooperation between the Management Company and the Trustee – the Management Company manages the FCC while the Trustee of the FCC's assets supervises the management company. The FCC is not an incorporated entity therefore the holders of the units issued by it have no voting rights and are not allowed to change the Company or the Trustee. Specific regulations regarding holders' rights, the role of the Company and the Trustee, their responsibilities, etc. are defined by Law.

It seems that while choosing a way to incorporate an SPE one must consider two main factors: SPE's separation from the Originator and efficient management of the SPE for the benefit of its bonds holders. Since the incorporation procedures that presently exist under the Israeli law do not answer these needs, we propose to set up a new legal entity, which will be defined under the Securitization Law and will be structured along the lines of the French model.[32] The aforesaid law has to define: a mechanism for the entity's management, rights of units' holders, responsibility of managers, various registration requirements, limitation of business activity of the securitizing entity, management qualifications, etc.

In the short term, and in accordance with the present law, it seems that the right way to incorporate an SPE is – as a private company. In order to separate the SPE from the Originator, unequivocally, it is desirable for the company to appear as a third party, with no affiliation to the Originator. At the same time the Originator must not hold any of the company's shares. In order to achieve efficient management of the SPE, for the benefit of its units' holders, various mechanisms have to be established as part of the company's codex. In contrast to a regular company, the purpose of an SPE is not to act according to a conventional business sense and to generate profits; in fact the founding and securitization agreements of an SPE have to limit its activity severely.

In this context an interesting question arises: how to classify the securities issued by the SPE, as shares or as bonds? The aforesaid classification is an important practical issue – if the SPE securities are issued to the public, it will be designated as a listed corporation with all the liabilities that apply to one; while at the same time if it issues bonds the SPE will be designated as a private company and the aforesaid liabilities will not apply to it.[33] It is worth clarifying that even if registered as a private company the rules of disclosure will apply to an SPE under the regulations of the Securities Law, by virtue of its being a "reporting corporation" under paragraph 1 of the Securities Law.

In a regular company structure, the shareholders enjoy the difference between the value of the company's assets and the value of its debt, and their return is not pre-fixed. Shareholders have a right to enact controlling mechanisms within the company. Bond holders are the creditors of the company and they get return on their investment in the form of interest, in other words they have a fixed return and a fixed maturity date. As a rule, bond holders do not posses the power to direct activities of a

[32] Also compare to the trust according to the Joint Investment Trust Law – 1994.

[33] See definitions of "public company" and "private company" under paragraph 1 of the Companies Law.

company, although sometimes they do have a certain amount of power to influence the decision making process in the company.[34]

Main criteria for the classification of securities are:

- **a.** Participation in residual risks and prospects: the larger the participation of the securities owner the more these securities are worthy of being classified as shares.
- **b.** Flexibility of rights affiliated with the securities: the more flexible the change of rights is, and the more it is subject to change and influence by the decisions made in the company, the more these securities are worthy of being classified as shares.
- **c.** Right of participation or the lack of it: the creditors are entitled to claim their contractual rights only, and are not entitled to any other additional rights.

An SPE does not have regular shareholders. The shareholders have no power to direct the company's activity (with exceptions stipulated in advance); they do not participate in residual risks and prospects, they do not hold voting rights and do not participate in effective dividends. The main activity of the SPE is - control and supervision of the securitization process since the rights and duties of its shareholders are derivates of this activity. Essentially there is no need to protect the SPE shareholders, in the same way regular shareholders in a listed corporation are protected and a special regulatory mechanism stipulated, under the Companies Law (regulations regarding outside Directors, sanction of transactions with controlling shareholders, acquisition proposals, etc.) is not necessary intended for their protection.
Moreover, all of the above is even more significant in regard to those who hold securities issued by the SPE, they do not have voting or dividend rights, do not participate in residual risks and prospects, the rights given to them are fixed and are not easily amendable and do not impart participation rights on their holders.
Under regular circumstances, the holders of securities are - bond holders, for all intents and purposes. Therefore an SPE that issues asset-backed securities to the public is not a listed corporation, but a private one.

Hereby, are the Committee's recommendations on the subject of judicial structure:

- **a.** The Securities Law has to stipulate the rank of entity that issues asset-backed securities and to regulate its functioning as well as the rights of its shareholders.
- **b.** In the short term, and in accordance with the present law, it seems that securitization will be carried out by means of the SPE companies. Under a regular state of affairs, the offer of asset-backed securities to the public shall not be seen as an offer of shares, but as bonds offer.

[34] Haviv-Segal, Companies Laws after a New Companies Law (volume 2)- 2004, p. 51-52.

4.4 Transaction classification as a sale or as a mortgage backed loan.

Transfer of Obligations Law, regarding two different types of transfer – transfer by means of sale and transfer by means of mortgage.[35] In a "sale" transfer the right of ownership goes to a Receiver, in a "mortgage" transfer the ownership right remains in the hands of a Transferor with a lien in favor of a Receiver, in order to insure the loan he extends to the Transferor.

The distinction between the transfer by means of a sale and the transfer by means of mortgaging - became a source of constant disagreement and debate, both in the court of law and in judicial literature.[36] First we shall examine the distinguishing aspects of securitization:

a. In a "sale" transfer, the ownership of right is transferred to a Receiver (SPE), and therefore in case the Originator goes bankrupt, the debtors' money will be paid to the SPE and not to the Originator's liquidator. Therefore, the main advantage of securitization, whose purpose is to separate between the transferred assets and the Originators assets, is achieved. On the other hand, in a "mortgage" transfer the SPE may, under certain conditions, be considered an insured creditor of the Originator, hence the materialization of assets becomes subject to the supervision of the court, in cases where the order for freezing of procedures has been issued.[37]
b. According to the approach, stipulated under paragraph 2(b) of the Mortgage Law – 1967, transfer by means of mortgaging will come under the regulations of the Mortgage Law. This means that transfer by means of mortgaging might require registration, which will act as prove toward other creditors of the Originator.[38] At the same time transfer by means of sale does not require registration.
c. Derecognition of transferred assets from the Originator's balance requires, according to the American accounting standards, submission of a legal opinion as proof of the transferred assets "true sale". Therefore the Originator will prefer to carry out a securitization that requires transfer of rights by means of a sale.

The question of applying paragraph 2(b) of the Mortgage Law has been discussed at length. It was widely interpreted in the **Colombo Affair**,[39] - the decision was that a transaction for supply of goods, between the supplier and the retailer according to the agreement that contained a stipulation of "ownership preservation", which stated that goods will remain the asset of the supplier until a full payment by the retailer is made, this transaction is considered as mortgaging of goods by the retailer for the benefit of the supplier. In the "**Northern drillings**"[40] case, the Supreme Court have cancelled this decision, as far as the credit transaction with an ownership preservation clause is

[35] Paragraph 1(b) of the Transfer of Obligations Law stipulates that "the transfer can be in regard to the right, in whole or in part, or it can be conditioned or by way of mortgage".
[36] See 455/89 **Colombo vs. Trade Bank ltd**, decision 490(5) (henceforth – **Colombo**).
[37] See paragraph 350(f) of the Companies Law
[38] See paragraph 178 of the Companies Law (new version) – 1983.
[39] **Colombo**, above, footnote 34
[40] **Northern Drillings** see footnote 34

concerned, but it also stated that the decision does not presume to examine the patterns of all possible commercial transactions. The rational, behind the Colombo decision, was to give validity to general aspects of the transaction and not to its formal shape as well as the apprehension that parties to the transaction will try to camouflage mortgage transactions in various ways in order to avoid the application of the Mortgage Law to them. This camouflage might, as aforesaid, hurt third parties - mainly the creditors of the seller (if they are of the opinion that there was no sale and the asset remained in the hands of the seller) as well as the creditors of the buyer (if they are of the opinion that a sale was carried out and the asset had passed to the buyer).

Professor Lerner[41] points out that, in order to differentiate between "sale" and "mortgage" transactions, there is a need to examine the true nature of the transaction according to the parties' intensions, as it appears not only on the basis of a written agreement, but from the overall circumstances of the transaction. According to Professor Lerner there are two main approaches to distinguish between the "sale" of right and the "mortgage" of right:

a. One approach is – to regard a transfer agreement that allows the receiver, who did not settle the debt, to settle it with the transferor later on - as a "mortgage" transaction; while an agreement that negates the right of return from a receiver to a transferor will be regarded - as a "sales" transaction.
b. Another approach states that it is not sufficient to be satisfied with the right of return to the transferor, and the difference between "sale" and "mortgage" is determined by the amount of risk a receiver is taking upon himself. In case all risks are carried by the transferor, the transaction is – a "mortgage".

According to the first approach, securitization can not be seen as mortgaging since the Originator can not reconsider the transfer and the SPE has no right to return assets to the Originator. On the other hand, according to the second approach, a question might arise regarding securitizations in which not all the assets are transferred to the SPE and some of them remain with the Originator.

Generally speaking, securitizations that are problematic in terms of "sale" or "mortgage" classification are those that include one or more of the following characteristics:

1 **Provision of bonds' settlement guarantee by the Originator**: provision of the aforesaid guarantee, by the Originator, ties him directly to the cash flow risks that he just sold to an SPE.
2 **Provision of a guarantee by the Originator for more backing assets (that weren't sold during the first stage) in order to support remunerations on bonds**: in this case the Originator is also a guarantor of the settlement on bonds, and thus is not cut off from the risk embodied in the non-payment of monies due to him according to the rights that have been transferred in securitization.

[41] see **Lerner**, footnotes 12, 110-111

3 **An Originator's guarantee to replace assets that have been transferred to the SPE and turned out to be non-performing assets, with other assets**: non-performing assets are assets that haven't been paid for, during a pre-determined period. For example, it is possible to classify a debt of a client as a non-performing debt, if it wasn't paid within a 30 day period, from the set date of payment. The Originator's obligation to replace the aforesaid securitized assets, which were apparently sold by him, with other assets is, in fact, an indirect guarantee by the Originator.

4 **Acquisition of subordinated notes by the Originator**: in many cases bonds are issued in tranches. For example, it is possible to divide subordinated notes into two tranches, so that the lower tranch will absorb 10% of the first cash flow that wasn't received, while the top tranch will absorb the remainder of the cash flow that wasn't received. Subordinated notes in the lower tranch carry higher risk, and the interest on them will be higher. There is no fault in division of risk as such, but at times the Originator will agree in advance, to acquire the subordinated notes and by doing so will retain a major part of the risk embodied in cash flow, despite the fact that he apparently sold them to an SPE.

5 **Residual rights retained by the Originator**: since it is expected that not all of the sold rights will produce cash flow, rights sold to the SPE, are expected to yield higher sums of money then the rights sold to the bonds holders. Stipulation that the surplus remaining in the SPE, after the settling of bonds' remunerations, will be transferred to the Originator means that the Originator retains financial interest in the rights he had sold.

6 **Provision of services by the Originator**: if the Originator acts as a service provider only, and the fees his services are not related to the performance of the assets, it will be difficult to argue that he retains part of the risk related to these assets. Nevertheless, if the fees for his services are related to the performance of the assets involved, then a certain amount of risk remains with the Originator.

These situations represent Originator's continuous involvement after transfer of assets.[42] Is the type or depth of this involvement has implications on the classification of securitization as a "sale" or a "mortgage"? Present day legal situation is not clear. There are two approaches that are applicable to securitization in this case: according to one – it has to be stipulated that the sale of assets in securitization is not subject to the amount of risk retained by the Originator. In fact, this approach negates paragraph 2(b) of the Mortgage Law regarding the securitization and the judicial certainty it creates. On the other hand, designation of securitization as "sale" might not necessarily go hand in hand with financial and accounting reality.
According to another approach – it has to be stipulated that securitization is a "sale" providing most of the risks embodied in the assets have been transferred from the Originator to the SPE. This approach faithfully reflects the economic reality, but it is difficult to stipulate quantitative economic criteria that will allow implementing it; therefore, this approach might not resolve the problem of uncertainty.

[42] It is worth noting that some of the described situations do occur in securitizations both in Israel and abroad. The most common situation is – acquisition of subordinated notes by the Originator that also carries financial sense: mostly the Originator is able to estimate the value of bonds accurately and refuses to sell them to third parties at a price lower then their value. Also by retaining some of the risks the Originator reduces his moral hazard.

In conclusion, one must take into consideration the intent underlined in the Colombo Decision – cautioning third parties and preventing the creation of masked mortgaging. This intent also applies to securitization; therefore it is only proper that the intent of parties involved in securitization to sell the rights shall be clearly presented to third parties, mainly to the creditors of the Originator. A relatively simple way of informing third parties is by means of registering the transfer with the Registrar of Companies. The question is, whether it is enough to warn third parties, if on the accounting level the securitization is transaction with as "financing" and the transferred assets remain on the Originator's books. It is important to remember that accounting and derecognition of assets from financial reports are done according to the Accounting Standard, therefore a gap might form between the legal and accounting considerations regarding this matter. This gap is undesirable and should be avoided.

4.5 Operational aspects

The "Car and Go" Affair has brought to light many problems regarding operational aspects of securitization. The separation between the Originator and the backing assets depends on the securitization technique as well as on the implementation of supervision of whatever is stated in the documents. It seems that in the case of "Car and Go", the debtors' money kept flowing into the Originator's account, and not into the SPE account, and the withdrawals that have been made from the SPE's account were not for settlements on bonds . In response to the "Car and Go" events, "Maalot" - the Israeli Company for Rating of Securities, which rated the transaction, has published a list of principals for tighter supervision and follow up of securitizations and for prevention of deception and violation of rules.[43]

These principals are a rudimentary base for any securitization. Nevertheless, in face of the importance of operational separation between the Originator and the backing assets, we propose to stipulate, under the Securitization Law, that the Minister of Justice shall be empowered to regulate this issue.

The regulations have to settle, among other things, the following issues: the mode of deposing cash into a trusteeship account of bonds' holders; transfer of debtors' standing orders to the trusteeship account, or vise versa, signing debtors on standing orders in favor of the trusteeship account; prohibition on carrying out movements on the trusteeship account without the trustees permission, payment date and means of payment to the servicer and the supervision over these payments; prior definition of terms under which the servicer will be replaced, and the identity of the alternative service provider that gave his agreement to fill the part. In addition, the regulations have to include detailed stipulation of the duties applicable to each of the parties in securitization, starting with the servicer and the trustee.

[43] "Maalot" - the Israeli Company for Rating of Securities, "principals of Securitization – from now on" 20.12.04

Chapter 5

5. Aspects of Taxation

5.1 General

In a classical securitization the transfer of rights for receiving the cash flow is - from an Originator of from a Source Company to an SPE (Special Purpose Enterprise) whose task it is to act as a legal framework for securitization, as well as a clearing house for money and their transfer to the bonds' holders.

Securitization creates taxation implications for three main parties – the Originator the Source Company (henceforth in this chapter - Source Company), the SPE and its rights holders. The classification of securitization will substantially affect the taxation rate of the parties' and might tilt the financial viability of the securitization itself.

According to the principal interpretation of tax laws the classification of securitizations, for tax purposes, generally follows the law and accepted accounting rules, unless otherwise regulated by the tax authorities. Therefore, where securitization (transfer or retraining of rights to an SPE) is seen as a "sale", according to both general and accounting laws it should also be seen as such for tax purposes.

Nevertheless, according to the rulings the income tax assessor may classify it differently from the general law, in case he became convinced that in light of the financial essence of the proposed securitization – it is a financing and not a sales transaction.

5.2 Discussion of taxation aspects

Securitization raises two main questions in regard to taxation, from which other tax implications are derived. These questions relate to classification - is it a "sales" or a "financing" transaction; and in regard to securities issued by an SPE – is it capital or is it debt.
The answer to these questions will be affected by the following issues:

- ✓ The way of defining the price of asset being sold at the level of a Source Company
- ✓ The issue of income classification – is it a capital gain or is it a profit income at the level of a Source Company
- ✓ The issue of remuneration separation for collection services, related to securitization, at the level of Source Company
- ✓ Income and expense matching at the SPE level
- ✓ The issue of tax deduction at source from the securitization income – income received from the clients of a Source Company and intended for an SPE, and income that is transferred from a Source Company to an SPE
- ✓ Enactment of the tax exemption, according to paragraph 9(2) of the Tax Ordinance, toward entities listed in that paragraph.

Henceforth is a short discussion on the issues:

5.2.1 First issue: Classification of a securitization for tax purposes – is it a "sale" or a "financing" transaction.

In securitization there is a transfer of contractual rights, for the receipt of cash, from a Source Company to an SPE. If we classify the transfer of rights as a "sale" that means that a Source Company sells assets to an SPE. On the other hand if the transfer is classified as "financing" it means that a Source Company has issued debt, backed by a special mortgaging of cash flow.

Henceforth is a review of alternative tax results for a Source Company and for an SPE:

a. Tax implications for a Source Company when securitization is classified as "sales":

If securitization is classified as a "sale", it means that a Source Company (the seller) had sold an asset and it has to pay tax on this sale. The question of classification is very important, if we talk about the sale of a capital asset, the tax rate on the capital gain, following the sales, will stand at 25% only. By comparison, if the income will be classified as profit the applied tax will be at a regular rate (which today stands at 34%). Obviously, there is certain apprehension regarding interpretation that will lead to a change of income classification as a result of securitization.[44]

In this connection, we would like to point out, that certain entities listed under paragraph 9(2) of the Tax Ordinance (New Version) (henceforth – the Ordinance), such as local authorities, pension funds, and institutional bodies may be exempt from tax, in case of the sale of rights, under the stipulation of the aforesaid paragraph.

Even after the securitization has been classified as a "capital sale" or as a "profit sale", the question will arise as to how the price shall be determined in regard to that sale.

In most cases, the cost of the transferred asset will be matched to the remaining cost, as listed in the books of a Source Company (for example: the remaining payment on the loan or a specific debt by a client); but at times it might be difficult to determine the value, for instance - where only a flow of income, without the actual asset that generates that income, has been transferred to an SPE and mortgaged in its favor (for example, income from the operational leasing or rights to receive rent).

Also, there might be cases where the sale of an asset will entail a loss. For example, in cases where cash flow of a client's dept is securitized - the income from this sale to a client has been fully reported by the Source Company even before the securitization.

In securitizations it is customary for the Source Company to act as provider of collection services, despite the transfer of the income rights. Mostly, the collection services are priced separately from the securitization itself, and the money for those services are received by the Source Company during the service period (the securitization period).

[44] In this connection, we would like to point out, that in light of the perennial tax plan that was passed by means of amendment 147 to the Tax Ordinance the capital gains tax and the Companies Tax will be equalized at 25%, and the amendment will be enacted from 2010.

Where securitization is perceived as a "sale" there is a need to separate the two transactions – the sales transaction and the service transaction. The securitization has to be taxed as a "sale" at the time of its consummation, while the servicing transaction has to be taxed during all of the service period (the securitization period) and expenses should be allocated appropriately.

Once the way to tax the "sales" securitization has been determined it must be insured against tax clearing at source by the clients, since the income is transferred through a Source Company to an SPE and the gains have already been debited to the Source Company.

b. Tax implications for an SPE when securitization is classified as "sales":

In securitization classified as a "sale" an SPE acquires an asset. Generally, the cost of asset acquisition will be equal to the cost of capital raising at the SPE. The acquired asset, therefore, is the source of income the SPE is entitled to.

As a rule, the income received by an SPE from a Source Company (as a service provider) will appear in the income column of the SPE books, while interest expenses paid to the bonds' holders, as well as expenses related to collection services (to which a Source Company is entitled) will appear in the expenses column.
In case capital shares are issued the interest expenses will not be registered.
There is a question that arises in this context: are all incomes received by the SPE taxable, or lest parts of them are a return on investment, similar to the base loan that is being repaid and is not considered to be an income. The alternative question is - is it possible to ascribe expenses calculated relatively to the cost of an asset, similarly to the amortization expenses, to the intake regarded as income?

There is no disagreement regarding the fact that if a stipulation is made that all intake is a taxable income and can't be ascribed to amortization expenses, then too wide a base for taxation will be created at an SPE, which in fact will include the cost of investment, and will threaten the financial viability of the securitization.

Even if a way is found to ascribe the cost of "asset's" acquisition to the income, for the duration of the bonds existence as opposed to the intake by an SPE, there still won't be a complete matching between the "asset's" amortization expenses and the interest expenses on bonds, from one side, and the intake (income) received by an SPE, from the other. Therefore, situations might arise whereby taxes will be paid because of the lack of matching adjustment between the income and the expenses of an SPE.

c. Tax implications for a Source Company when securitization is classified as "financing":

If securitization is classified as "financing" of the Source Company, meaning - a capital raising transaction with the mortgaging of a particular, securitized income flow, then the Source Company shall be seen as an issuer of bonds (or loan acquirer) with the mortgaging of a particular income flow from the backing assets. In this situation the securitization money (similarly to a bank loan) are not recognized as an income at the Source Company. In the future, when profits generated by the contracts of a Source Company with its clients will come in, then and only then, will taxation begin.

Simultaneously, and in line with this approach, interest payments to investors in the SPE bonds will be deduced from the aforesaid income, as if we talk about interest expenses on a loan taken by a Source Company.

In a "financing transaction" the clients might deduct taxes at source from the payments to a Source Company (and through it to an SPE), in accordance with a valid tax permit, which is held by a Source Company.
The aforesaid tax reduction might interfere with the cash flow, since the SPE bond holders expect to receive full income from the clients, without at source tax deductions, related to the tax debts of a Source Company.

d. Tax implications for an SPE when securitization is classified as "financing":
Simultaneously, and with a careful examination of the securitization, as a financing transaction for the Source Company, there is no place to tax an SPE in order not to create a "double taxation" or a "double expenditure". Therefore, the intake received by an SPE will not be considered as income and the interest paid by an SPE to the bonds holders will not be regarded as an expense.

5.2.2 Second issue: Classification of SPE debt holders as capital holders or as debt holders

A Special Purpose Enterprise, created for securitization, is an auxiliary corporation whose purpose is to service the securitization. As a rule with the end of securitization the SPE is dismantled.

In light of the aforesaid, one can state that this corporation does not aim to generate profit for bonds' holders as does a regular LTD company according to the Companies Law. In case of an SPE we talk about a non-profit corporation, which is designed to act as a clearing house for the securitization money; so that one party shall receive the income from the rights transferred to it by a Source Company and the other party shall transfer this income to the bonds' holders, on time.

In fact, the risk takers at an SPE are the holders of bonds and not the shareholders that do not have a real financial interest in the company.

In this case, the income tax assessor may classify the securitization in a different way and claim that securities, which have been issued by an SPE, are in fact, capital and the holders of bonds are, in fact, capital owners (in a way shareholders are) and therefore the moneys distributed to them are not interest on debt but – dividends. A known rule is that a remuneration of dividend does not constitute a deductible expense, since it is not made as part of an income creation but only after the income has been generated.
In this case the taxation will be particularly heavy. If we refer to securitization as to a "sale", then the SPE's intake will be regarded as an income and since there is a lack of recognized tax deductions – the tax rate will be particularly high.

In case where bond holders of an SPE are classified as debt owners and not as capital owners, the remunerations made to them (the element of interest in the remuneration) will be recognized as an SPE's or a Source Company's, expense and in this way the income/expense ratio will be more appropriately balanced. Under such circumstances

the element of interest in the SPE's remunerations to debt holders will be classified by them as income from interest. Therefore, where debt holders are eligible for tax exemption, under the regulations of paragraph 9(2) of the Ordinance, their income from interest will be tax free. On the other hand, where debt holders are not eligible for tax exemption they will be taxed at a full rate (marginal tax / company tax) or at a limited rate of 15% (or 20% beginning from 2006[45]), which applies to interest on bonds held by individuals and traded on the stock exchange[46].

Sometimes, the structure of a particular securitization places the overall relative risk related to the bonds, on the lower tranch bond holders, which are sometimes held by a Source Company. In these cases, the lower tranch bond holders will be entitled to receive the money from an SPE only after all top tranch bond holders have received their money. Therefore, one might argue that since the overall risk related to the bonds falls mainly on the lower tranch bond holders (generally held by a Source Company) one might see at least them, as capital holders and not as debt holders and the sum invested in bonds' acquisition as a capital sum and not as a debt sum. In this case tax implications, detailed above, will apply only to the lower tranch bond holders.

5.3 The Proposed Tax Model

5.3.1. Principals of the Tax Model

- ✓ The tax model has to support securitization and to allow its execution, with attention to cash flow and characteristics of the parties' involved.
- ✓ The tax model has to bring about a fair result, so that "duplicate taxation" or "lack of taxation" will be avoided
- ✓ The tax model has to strive to reduce or to solve the problem of "matching" between the income and the expenses.
- ✓ The tax model has to insure the payment of tax on the securitization
- ✓ On one hand, the tax model has to take into consideration the way in which the parties chose to carry out the securitization, and on the other – the real financial nature of the transaction.
- ✓ The tax model has to be clear and simple, as much as possible.

5.3.2. Tax Model - General

As aforesaid, according to the existing tax principals both the classification and the taxation of a securitization follow the accepted legal and accounting rules, unless otherwise stipulated. In general this means – where securitization is seen as a "sale" according to the law and accepted accounting rules (transfer of rights to an SPE) it should also be seen as "sale" for tax purposes.

[45] According to the perennial tax plan, as stipulated under amendment 147 of the Tax Ordinance.
[46] Paragraph 125c(b)(2) of the Tax Ordinance

Nevertheless, in certain securitizations, in light of their financial substance it will be possible to acquire a pre-rolling certification, from the tax authorities, according to which the securitization may be classified, for tax purposes, as "financing" - as if the issue of bonds has been done in advance, by the Source Company.

5.3.3. Tax Principals for Securitization Classified as a "Sale"

Conditions for a "sale" securitization:

1. A new designated corporation (SPC), based in Israel, has been establish for securitization purposes (henceforth the "Designated Corporation"). A case where a Designated Corporation has been established abroad will be examined separately.
2. The only purpose of the Designated Corporation is to service the securitization, meaning – issuance of bonds to investors, acquisition of cash flow rights from the Source Company and monetary clearance of cash flow for bond holders in the Designated Corporation.
3. The securitization has been classified as a "sale" according to the customary accounting regulations
4. Designated Corporation shall be dismantled with the expiration of the securitization period and desistance of the cash flow intake; the remainder of assets, if any, shall be transferred to the SPC's rights' holders.
5. A clear separation exists between securitization and provision of services.
6. Designated Corporation has issued general rights (of various types) and service rights (of one type). The service right will be defined separately.
7. The main aim of the securitization is not to avoid or reduce tax payments in an improper manner.

Tax principals in a "sale" securitization:

Source Company:

1. Securitization shall be designated as a sale in case the following conditions are fulfilled:
2. Transfer of rights to a Designated Corporation shall be considered a profitable sale, on the date of securitization, by the Source Company on behalf of which a loss/profit will be recognized.
3. Regarding the component of bonds that have remained in the hands of the Source Company, if at all, the sale of rights related to them will not be recognized as loss or profit. The rights will be transferred to a Designated Corporation according to their cost. If and when the Source Company sells the bonds then the surplus profit / loss will be recognized.
4. The accompanying service transaction will be taxed separately from the securitization, and for the period of the service provision to the Designated Corporation (generally the securitization period).
5. The Source Company shall be granted a tax certificate for the clearing of taxes at source against the intake it will receive during the securitization period from the clients in order to transfer it to a Designated Corporation.
6. Securitization (the sale of rights to receive future cash flow) will not be VAT taxed by the Source Company, which is the Originator. Future

transactions related to securitization shall be reported by the Source Company, including issuing of tax receipts to the clients of the Source Company as well as tax payments related to these transactions. Source Company, which is a financial institution securitizing financial assets, will have to pay tax on gains at the time of securitization.

7. Handling of tax for profit/loss recognition of the banking institutions is subject to the supervision by the Supervisor of Banks, it will be similar to the accounting handling of the securitization, as has been approved by the Supervisor of Banks.

Designated Corporation:

1. Designated Corporation shall register the acquired asset (the rights to receive future cash flow) in its books according to the sum it has paid for it (market value on the date of securitization).
2. Designated Corporation will be exempt from tax on its income (the taxation will be in the hands of the residual rights owners).
3. Designated Corporation will be given a tax exemption, from at source tax clearing, on the in income it receives from the Source Company as part of securitization.
4. Classification of the Designated Corporation, for the purposes of the Value Added Tax Law, shall generally be that of a "Financial Institution".

Investors of the Designated Corporation:

1. Holders of general rights in the Designated Corporation –
   Holders of general rights in the Designated Corporation shall be considered as debt holders and not as capital holders (generally they invest in bonds issued by the Designated Corporation). The interest component received on the rights (bonds), by the holders of general rights, will be either taxed or tax free - according to paragraph 9(2) of the Tax Ordinance, subject to the regulations stipulated under it. Separation rules, regarding the separation between principal and the interest, shall apply to the discount issue of bonds, and the reporting will be on the basis of accumulation.
2. Holders of general rights in the Designated Corporation –

   a. Holders of general rights, in the Designated Corporation, will be taxed on the profits of the Designated Corporation since these profits are regarded as holders' residual income.
   b. In profit calculations the element of income from cash flow shall be taken into consideration, while in expense calculations the element of interest on the rights of debt holders shall be taken into consideration.
   c. Taxation of the residual rights holders, in regard to the income ascribed to them from the Designated Corporation shall be on the basis of accumulation.
   d. Limitations might be applied to the identities of residual rights holders, to ensure tax payments to the treasury.

e. The actual distribution to residual rights holders will not be taxed (as a partner in a partnership), since the income from which it is derived has already been taxed on an ongoing bases, with the exception of distributions that are above the original price of the residual rights holders.
f. Every year a cost adjustment of the remainder of the residual rights shall be carried out for tax purposes of the residual rights holders (similarly to the cost of right of a partner in a partnership), in such a way that a gain ascribed to the residual rights holder – increases the original price, while the ascribed loss – reduces the original price up to zero, distribution of cash reduces the original price, etc.

5.3.4. Tax Principals for Securitization Classified as a "Financing"

Conditions for the acquisition of a pre-rolling certificate:

1. A new and separate SPC company has been created for the securitization, with the exception of a Revolving securitization, (henceforth – "Designated Corporation").
2. The sole purpose of a Designated Corporation is to issue bonds to investors, to acquire cash flow rights from a Source Company and monitor the clearance of cash flow to bonds' holders. The assets of a Source Company are the cash flow rights and its liabilities - are the bonds.
3. The securitized assets are one of the following:
   a. Assets that are *not* included in the assets which are subject to securitization according to FAS 140/IAS 39, meaning – are not considered *financial assets* ("*financial assets*" – loans, clients' debts, funding leasing, etc.). Therefore, according to this alternative it is possible to securitize cash flow from operational assets, for example, rental income, operational leasing, etc.
   b. Financial assets which according to accepted accounting rules are not regarded as sold by the Source Company (in this alternative the reason for assets to be regarded as not sold shall be examined).
4. Bonds (possibly of different types) will be issued to investors as part of securitization.
5. All of the residual rights (shares, generally) in a Designated Corporation will be owned by a Source Company. The residual right shall be determined separately.
6. With full redemption of securitization the Designated Corporation shall be dismantled and all remaining assets and cash (whatever is left of it), will be transferred to the Source Company.
7. The return on the issue shall be used by a Source Company for its business activities.
8. Inappropriate tax deductions are not the aim of securitization.

Taxation Principals in accordance with pre-rolling certification:

1. Under the following conditions the securitization shall be regarded as bonds' issue by a Source Company. Therefore, the transfer of rights from a

Source Company to a Designated Company shall not be considered as "sale" by the Source Company.

2. All income, expenses, assets and liabilities of a Designated Company will be regarded (for tax purposes, including Inflation Adjustment Act) as income, expenses, assets and liabilities, accordingly, of a Source Company. The Designated Company shall not have any tax recognizable loss or income.
3. With full redemption of securitization the Designated Corporation shall be dismantled and all remaining assets (if any), will be transferred to the Source Company. Dissolution and transfer will not be taxable, as aforesaid.
4. Bonds that are not held by a Source Company will be designated as debt and not as capital.
5. A Source Company shall be issued a certificate of exemption for at source tax clearing, on the income collected from its clients and transferred to a Designated Corporation, according to stipulations that will be agreed upon.
6. Designated Corporation shall be given a certificate of exemption for at source tax clearing, on the intake received from a Source Company.
7. Designated Corporation shall be required to clear tax at source, from interest remunerations to bonds' owners, according to specific certificates of bonds' owners or according to exemptions they are entitled to according to the law.
8. In case a Source Company enters the insolvency proceedings, the date, on which the grounds for insolvency had first appeared at the Source Company, shall be seen as a date for the application of gains tax on the proportional gain, which stems from transfer of rights to a Designated Company, that has yet to be taxed as part of the current cash flow.
9. The sale of residual rights (generally, share capital) in a Designated Corporation by a Source Company shall be regarded as a taxable event, on the remainder of the securitization money that haven't been taxed yet; this will apply to a "sale" securitization with required changes (endorsement by the Chairman of the Tax Authority is required).
10. Designated Corporation shall not be required to carry out a separate registration in accordance with the VAT Law. Source Company shall continue to report, to issue tax receipts and to pay VAT on transactions related to securitization.
11. In case the securitization is that of a long term rental income from real estate, where investors (bonds' holders) have been promised a large part of the asset's value by the end of the securitization period, the case shall be examined separately, also in light of the stipulations under the property tax law.

The Committee recommends that the aforesaid principals will be stipulated under law.

6. Aspects of Banking and Banking Supervision

6.1 General

All over the word banks tend to act as Originators, Transferors, Receivers and Providers of securitization services. The main assets securitized by the banks are mortgage loans, loans to corporations and others, income from credit cards, etc. Due to the role the banks' play within the financial system and due to their importance to the market's stability, banks' activities are regulated by means of a singular regulatory system. In regard to securitizations, one has to resolve a number of basic and unique issues related to the banks' activities in this field:

a. **Capital adequacy:** All over the word banks function under regulations that require from them to retain a minimal capital ratio, at all times. Derecognition of assets from the banks' balance, in return for cash, diminishes the risk of credit to which they are exposed and might improve their ratio of capital adequacy. The influence of securitization on the rise of capital ratio acts as another incentive for carrying it out; an influence which does not exist in other entities.
   Regulations of the banks' supervising authorities stipulate whether, following the securitization, a bank is entitled to release capital held as collateral against the credit risk of assets before their securitization, in case securitization reduces the risk of credit which remains with the bank after the asset transfer. One of the misgivings in this regard is that banks might do "Cherry Picking", meaning – they will choose their best assets for securitization, in order to gain high rating and high return on the transaction, while retaining their riskier assets in their possession. In this way the capital adequacy requirement, which presumes diversity and the spread of risk in banks' assets, will not be preserved.
b. **Moral Hazard:** In many securitizations the bank transfers the credit risk, related to the transferred assets, but goes on acting as a Service provider, thus remaining in touch with its clients and borrowers. The misgiving in this case is that under certain circumstances a bank might feel responsible and obliged to interfere, in regard to the transferred assets, in order to preserve its relationship with the existing clients, or in order to prevent damage to its reputation in regard to its shareholders, if following the realization of the credit risk related to the transferred assets their rating goes down. For example, the bank might buy back a loan that wasn't repaid, in order not to endanger future relationship with the client. In order to ensure that a bank will not get into the aforesaid situation, the supervising Authorities will be required to stipulate regulations ensuring effective severance between the bank and the SPE.

The Supervisor of Banks recognizes the importance of the credit risk transfer, by means of securitization (traditional and synthetic), and by other means that are part of the credit risk management of banking corporations. A credit risk transfer, by means of traditional securitization, will be recognized for the purpose of accounting presentation in financial reports of a banking corporation only if it was carried out

according to the regulations of the American supervising authorities[47] and has been registered in accordance with American accounting regulations (SFAS 140), as practiced within the American banking system.

The Supervisor of Banks recognizes the need and importance of the establishment of a securitization market in Israel, for the credits of housing tenants, car buyers, credit card users, etc., all that as long as securitizations involving banking corporations will be carried out in the usual way and by complying with the requirements, some of which are listed below, and in accordance with the regulations that will be stipulated by the Supervisor of Banks at a later date.

6.2 Regulations for securitizations carried out by banks

Henceforth are the main conditions for the asset securitization by the bank. We would like to point out that the following regulations relate, mainly, to securitizations which in terms of accounting are presented as "sales" and are derecognized from the books of the bank who is a Transferor. It is because most of the stipulated terms are not relevant if the "sale" is not recognized.

6.2.1 Accounting presentation of securitization

According to recommendations made by the Israel Accounting Standards Board, it is expected that the Accounting Standard stipulating recognition and derecognition of financial assets, and which is based on the International Standard IAS 39, will go into effect in 2008. Until then the banks have to act according to the regulations stipulated under the American Standard SFAS 140, as published by the Supervisor of Banks and in a manner in which it is applied to financial reports of the American banks.
After the enactment of the Israel Accounting Standard based on the International Standard IAS 39, it will not apply retroactively to securitizations that have been signed by the banks prior to its enactment. The representation of the aforesaid securitizations, in financial reports of banking corporations, will continue according to the regulations stipulated under the American Standard SFAS 140.
After the publication of the obligatory Standard 39 IAS, the Supervisor of Banks shall consider his position regarding the regulations for the representation of securitizations, which have been carried out after the enactment of this new Standard, in financial reports of a banking corporation.

6.2.2 Credit Enhancement for bonds remuneration

6.2.2.1 A banking corporation that has transferred financial assets by means of securitization shall estimate the value of the rights that are retained in the transferred assets, at the time of transfer, according to their relative fare value. In case the retained rights are deferred for the benefit of more privileged rights in the transferred assets (henceforth – deferred rights that have been preserved) it must be taken into consideration at the time of their relative fare value estimation.

6.2.2.2 The fair value of the deferred rights that have been preserved shall be calculated on reasonable, conservative valuation assumptions, which can be

[47] Interagency Guidance on Asset Securitization Activities, 13.12.1999

objectively verified. Accurate documentation supported by documents of the right's fair value, utilizing reasonable, conservative valuation assumptions that can be objectively verified, according to the standards stipulated by the Banks' Supervising Authorities in the US[48], must be preserved. In case the retained rights lack such objectively verifiable support they have to be immediately deleted (the handling of financial assets' transfer, when it is not possible to provide their reasonable and objectively verified evaluation, is clarified in Standard 140 paragraphs 71 and 72).

6.2.2.3 After primary recognition of deferred rights that have been preserved, the balance remainder of the of deferred rights will be deducted according to a strait line along the remuneration period of the deferred rights, but not longer than a 36 months period from the date of their creation (at the end of the first month 1/36 will be deducted from the balance, at the end of the second month 1/35 of the balance and so on).

6.2.2.4 On each reporting date the need for registration allocation, due to decrease in value of the deferred rights, has to be examined.[49]

6.2.2.5 If, after the securitization, part of the deferred rights retained for the non-affiliated[50] parties is sold to the Transferor, the deferred rights that remain - will be evaluated according to the regular rules of accounting.

6.2.2.6 Until the recommendations of the Basel Committee II[51] are implemented, a bank is not allowed to invest in securitization bonds of a non-affiliated party, with the exception of the high upper tranch bonds.

6.2.3 Prohibition on repeat acquisition of loans transferred to SPE by a bank

The transferring bank shall not be allowed to buy back, directly or indirectly, a loan it has sold to an SPE, except for the irregular instances of fraud. Nevertheless, when there is a very short period of time left to the expiry date of the loans portfolio sold to the SPE (for example, in the last of 10 years or when the balance of the portfolio goes down to 10% of its original value), and if it is allowed by the securitization agreement, the Transferring bank will be allowed to carry out a "Clean up" and to buy back, from the SPE, the remainder of the loans at their fail value. That in order to save the management expenses of the securitized loan portfolio.

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[48] see "Interagency Guidance on Asset Securitization Activities", from 13.12.99, there it was stipulated that: "This guidance…emphasizes the specific expectation that any securitization related retained interest claimed by a financial institution will be supported by documentation of the interest's fair value, utilizing reasonable, conservative valuation assumptions that can be objectively verified. Retained rights that lack such objectively verifiable support or that fail to meet the supervisory standards set forth in this document will be classified as loss and disallowed as assets of the institution for regulatory capital purposes.

[49] See – EITF 99-20 "Recognition of interest income and impairment on purchased and retained beneficial rights in securitized financial assets".

[50] 1). **Affiliate** – according to the American Standard no.57: party that controls the corporation is controlled by a corporation or is under a shared control with a corporation, directly or indirectly, through a broker or a number of brokers.

2). Provident Fund and Mutual Trust Funds that are managed by the Transferor or by the parties considered close to it, according to the aforesaid paragraph 1.

[51] Regulations in regard to the minimal capital ratio that have been stipulated by the Supervisor of Banks in Israel are based on the Basel Committee recommendations for minimal capital ratio calculations, first published in 1988. In June 2004, the Basel Committee has published new recommendations for minimal capital ratio calculations (Basel Committee II), which are meant, among other things, to adjust the minimal capital ratio calculations to progressive methods of risk management, and to clarify the management of complex transactions, such as securitizations.

6.2.4 Support Prohibition on SPE liquidity

In case of liquidity difficulties at the SPE, the Transferring bank and the affiliates will not be allowed to supply sources to support the SPE's liquidity, either directly or indirectly. The liquidity risk, if it appears, will fall squarely on the shoulders of the bonds' holders or non-affiliated third parties (such as – entities that supply instruments of "liquidity support" to the bonds).

6.2.5 Transferring bank as a Servicer

In regard to the loans sold to an SPE, the transferring bank may continue to act as a Servicer only, and to present the service contract in its financial reports as stipulated under the American Standard 140, if it receives an adequate return for its services.
In order to protect the rights of borrowers, in securitization, it shall be stipulated that at the time of the replacement of Servicer the alternative Servicer will also be a corporation that falls under the regulations of the Supervisor of Banks regarding the rights of borrowers (see paragraph 6.2.9).
The Transferring bank shall not be prevented from applying sales accounting to a securitization in which it acts as the SPE's Servicer, if common sense it applies complies with regulations that have been stipulated under the American Standard 140.
Until such time, when enough experience has been accumulated and the Supervisor of Banks shall stipulate appropriate regulations, the Supervisor shall examine a securitization and decide upon:

a. The fee for acting as a Servicer

b. If common sense a Servicer applies, complies with regulations that have been stipulated under the American Standard 140

c. The arrangements have been made to protect the rights of borrowers in view of sale of their loans

6.2.6 Compilation of loans' Portfolio to be sold to SPE and prevention of "Cherry Picking"

To prevent quality impingement of the credit portfolio of the Transferring bank, the selective sale of "good" loans to an SPE shall not be allowed. Nevertheless it will be possible to sell to an SPE, portfolios that have been randomly chosen from a particular category (for example, dollar linked loans, index linked loans, non-linked loans, home mortgages, home backed second mortgages, car loans for the purchase of private cars etc.), providing the quality of the loan for sale is not a criterion for the loan's inclusion or exclusion from the portfolio, offered for sale.
The aforesaid not withstanding, at the time of the mortgage portfolio sale, in case the allocation for bad debt is calculated according to the depth of debt[52], the Supervisor of

[52] Allocation according to the depth of debt is a system described in the appendix to PROPER CONDUCT OF BANKING BUSINESS REGULATIONS no. 314 " Dealing with Problem Debts", according to it banking corporations are required to calculate minimal allocation for bad debt on home mortgages, in accordance with the rates stipulated under the regulation. Generally speaking, the longer

Banks shall allow the Transferring bank to, randomly, take out of the offered portfolio those loans that at the time of securitization are considered to be in arrears.

6.2.7 Limitations on transactions with affiliates

Parties affiliated with the transferring bank (for example: provident funds and mutual funds owned or managed by the bank) will not be allowed to purchase bonds issued by the SPE during the securitization in which the bank is a participant.

6.2.8 Gaps in the remuneration period

6.2.8.1 Revolving Securitization - the Supervisor of Banks shall approve the revolving securitization of short term credits, such as credits on credit cards.

6.2.8.2 Transfer of risk by means of securitization will not be recognized as sale if the effective payoff period on bonds is shorter then the effective payoff period on credit securitization. For example, the effective payoff period on bonds is 3 years, while on securitized loans the effective payoff period is 6 years.

6.2.9 Rights of borrowers

Rights of banks' borrowers are stipulated under the general law, special regulations that apply to some borrowers, borrowing from a banking corporation, are stipulated under the PROPER CONDUCT OF BANKING BUSINESS REGULATIONS of the Supervisor of Banks and according to the practice that exists at the banking corporations.
The situation of borrowers, who for example, have taken out a housing mortgage, will not worsen due to the sail of their loan by a bank, as part of securitization. In every securitization, arrangements fitting the specific securitization will be made to protect the rights of borrowers whose loans have been securitized.

6.3 Summary

In order to facilitate the development of the securitization market in Israel, the Supervisor of Banks shall examine each securitization separately; those that will comply with the requirements will be given a pre-rolling certificate. With the acquisition of proper experience the Supervisor of Banks shall issue stipulations for the regularization of securitizations.

Chapter 7
7. Trade and Disclosure on the Stock Exchange

7.1 General

The Securities Law, 1968, (henceforth – Securities Law) and its Regulations stipulate disclosure liabilities in regard to corporations seeking to issue securities to the public. The breadth and content of disclosure in the company's prospectus depends, among

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defectiveness on the payment of home mortgages is, the bigger the allocation - the banking corporation is required to set aside for bad debt.

other things, on the singular characteristics of a particular issue (corporation's business, its risk factors, control structure of a corporation and so on), although the Securities Law and Regulations, by their very nature, point out in advance, the details of disclosure that are usually required. Regulations regarding disclosures in a prospectus are detailed under paragraph 16 of the Securities Law; they stipulate that any detail that might be important to a reasonable investor who considers buying securities offered according to the aforesaid prospectus must be included in it, as well as all the details stipulated under the Regulations. Also, the prospectus must not include any misleading information.

Securitization requires a renewed thinking in everything that relates to the advisable disclosure model. Contrary to a regular issue of securities, in the issuance of bonds the description of the SPE's (issuing corporation) business is not particularly important, what is important is to broaden the discloser regarding the structure of the transaction, the backing assets, servicing of the securitized assets – including collection of money. It is also important to examine as to how the on going reporting, which is mandatory after the issuing of bonds, will be implemented.

The Bachar Committee (committee for the examination of disclosure requirements for a prospectus offer of commercial securities or non-conversable bonds, was chaired by Reuben Bachar, Attorney at Law; henceforth – the Bachar Committee) has published its conclusions on August 26, 2003. The Committee referred to the disclosure required from a public issuing of the asset-backed non-conversable bonds, in general terms, and its recommendations are not specific enough for this purpose.

At the beginning of January 2005, the Securities and Exchange Commission in the US has published rules stipulating disclosure liabilities in regard to assets-backed securities (henceforth – the American Rules).[53] These rules create a standard of disclosure that is different from what is customary accepted in securities offering to the public; the fact that raises serious questions regarding the desirable disclosure model. Nevertheless, our ability to draw conclusions, based on these regulations, is limited at present: the American Rules are designed to regulated a sophisticated securitization market, that has been functioning for years, they are based on experience and practice which are common in the US, while in Israel there still haven't seen public offerings of asset-backed securities. Also, in case the present framework of disclosure based on the Securities Law does not act as a substantial prohibitive barrier to public offerings of asset-backed securities, the main question remains – is it possible to implement a disclosure framework, for the short term, without legislative amendments.

In the light of the aforesaid, the Committee's recommendations will concentrate on a number of main issues related to the advisable disclosure model, and will not transaction with specific disclosure regulations or particular issues related to securitizations issuing; since as far as we can see will not be carried out in the first stages of the securitization market establishment. We assume, that in the field of securitization, similarly to other fields, the ISA will develop a practice in regard to details requiring discloser in prospectuses and reporting, which will be anchored in law after enough experience have been acquired in this kind of issuing.

[53] Securities and Exchange Commission, Asset-Backed Securities; Final Rule, January 7, 2005.

Main subjects for discussion are:

a. Identity of the entity responsible for reporting
b. Details that have to be included in prospectus for the issuing of asset-backed bonds
c. Details that have to be included in the current reports of a corporation that issued the asset-backed bonds
d. Details that have to be included in the report of an Originator, which is a reporting corporation that had carried out securitizations
e. Rules of bond registration and trade on the stock exchange.

7.2 Entity responsible for reporting

Paragraph 15(a) of the Securities Law stipulates that a public offer of securities shall be carried out only according to a prospectus approved for publishing by the ISA. Generally, public offerings of securities are carried out by the issuing corporation (namely, the issuer is also the offeror), and the issuing corporation is bound to publish a prospectus. With the publication of the prospectus, the aforesaid corporation – whose securities have been offered to the public, becomes a "reporting corporation", as defined under paragraph 1 of the Securities Law; it will also fall under the reporting liabilities, according to paragraph 36 of the Securities Law, and the responsibility that stems from non-compliance.

The proposal is – not to deviate from this standard and to designate an SPE that offers securities to the public as an issuer and as a reporting corporation responsible for reporting to the bonds' holders. The question that arises therefore is - does a requirement for reporting must also apply to other parties to securitization, such as the Originator, the Servicer and creditors – since an SPE which is bound by disclosure regulations is dependant on the information they posses.
One has to keep in mind that asset acquisition by an SPE, is generally done on the eve of the securities issuance, hence the source of information regarding these assets – that is the essence of the prospectus – is the Originator. We therefore propose that for the time being the ISA shall not require other parties to securitization to submit a direct report and will leave it up to an SPE (the issuer and the offeror) to ensure it has the means to submit all relevant and important information that might be expected by a reasonable investor, according to the Securities Law and the Regulations pertaining to it. Direct responsibility for providing all relevant information shall be, therefore, imposed on the SPE.

7.3 Issuing of prospectus for the asset-backed bonds.

7.3.1 Extent of disclosure.

The transfer of backing assets to an SPE is done in order to isolate them, in legal and economic terms, from the rest of the Originator's assets. As aforesaid, in disclosure terms it means that where a separation took place an SPE prospectus has to include the relevant information that describes the SPE in question, it's backing assets and the

structure of securitization. There is no need to include a full description of the remaining assets and other activities of an Originator in this prospectus. The aforesaid is based on the assumption that in case of total separation, investors' considerations for purchase of bonds are based on risks and prospects embodied in the backing assets, whiles other risks and prospects which stem from the Originator's other activities remain his own lot that does not concern the holders of bonds.

On the other hand, in case there is no legal and economic separation of the backing assets from the Originating corporation, creditors that hold bonds are endangered by general insolvency of the Originator, therefore, in this case the description of the backing assets only is not sufficient. Seemingly, the transfer of assets to a separate legal entity is intended to secure sufficient separation between an Originator and an SPE, however taking into consideration the newness of a securitization instrument as well as the lack of legislation or regulation on the subject (including clearly defined rules for the sale of backing assets), it is necessary to stipulate circumstances under which additional disclosure will not be required from the Originator. It is worth noting that even in cases where the assets have been sold according to the relevant judicial and accounting rules; a disclosure regarding an Originator might be required if dependence exists between him and an SPE, therefore the following conditions have to be seen as guide lines only.
For example, in case there is no other Servicer except for an Originator, which can step in, in case of insolvency, the payment of prime and interest on the bonds will depend on an Originator, hence the requirement for an extensive disclosure regarding him. Therefore, a disclosure might be required regarding an Originator even in cases that do not carry a shadow of a doubt regarding the sale of assets.

In light of the aforesaid, there are two possible ways to deal with disclosure[54], in the issuing of asset-backed bonds:

- **a** The prospectus and current reports will include full disclosure regarding an Originator in addition to the disclosure regarding an SPE and its backing assets.
- **b** The prospectus and current reports will not include disclosure regarding an Originator, but will mainly concentrate on an SPE and its backing assets.

In order to be included in the second track that is a special disclosure track for asset-backed bonds, the following conditions have to be fulfilled:

- **a** The Accounting Standard, valid at the time of the offer, recognizes derecognition of assets from the Originator's balance, all or in part and the SPE reports are not amalgamated with the Originators reports.
- **b** The Originator and the SPE are non-affiliated parties, with the exception of a securitization affiliation (that might also include servicing)
- **c** The group of mixed assets shall include financial assets only.
- **d** The existence of operation control system that ensures the transfer of money to the SPE and its safekeeping for the benefit of bonds' holders.

[54] As will be detailed henceforth, the extent of disclosure in current statements will be defined according to the extent of disclosure in the prospectus.

An offer of asset-backed bonds that does not comply with the aforesaid conditions will be required to submit additional disclosure regarding the Originator, and will not enjoy the advantages of a special disclosure track. One must note that after the enactment of the Securitization Law there will be a need to re-examine these conditions, and to adjust them to the Regulations of the Law.

In case a private company wants to issue bonds to finance a project, future intake from which will provide financing for the remuneration on bonds', - in such a case we talk about the issue of project bonds, by a corporation establishing a project, and a full disclosure will be required from such corporation.

A. **Details regarding an SPE**

Although there are no limitations in law regarding the way an SPE should be incorporated, to date, only incorporation as a company will allow an SPE to register for trade on the stick exchange; this type of incorporation will also provide the best possible protection to bonds' holders. Generally, securities issued by an SPE should be regarded as bonds (as oppose to shares),[55] hence an SPE will be a private company according to the Companies Ordinance, and a "reporting corporation" according to the Securities Law - which comes under the disclosure regulations of a company that offers its securities according to a prospectus.

A positive indication of a real financial transaction and transfer of risks and prospects, embodied in the backing assets, from an Originator to an SPE – exists when they are non-affiliated parties. The existence of a material connection between an Originator and an SPE, particularly Originator's control over an SPE, might impede the severance of assets and increase the danger of raising the curtain on the incorporation, according to paragraph 6 of the Company Ordinance. In light of the aforesaid, we propose to stipulate – that in order to be included in a special disclosure regime in regard to the asset-backed bonds, the only affiliation between an SPE and an Originator has to be for the purpose of securitization.

B. **Backing assets.**

In line with the American rules, the Committee is of opinion that there is no need to stipulate in advance a "closed list" of assets that are subject to public issuance; there is a need to allow securitization of various assets, as long as a basic principal of dealing with financial assets (with the exception of shares) that will be converted according to their stipulated conditions into cash, within a pre-determined period of time, is upheld. Therefore it follows that possible backing assets are – clients' debts, loans, including mortgages, credit cards, etc. Also there is no reason why a group of assets should be static and not revolving as long as a clear criterion has been predetermined in regard to this matter.

In order to facilitate a qualified investment decision, a group of backing assets has to be characterized by a predetermined composition of assets that can not be replaced with time. This requirement for a discrete group of assets is also stipulated under the American rules, and we propose to adopt it in Israel. Also, although there is nothing

[55] See section 4.3 of this Report

that can prevent a future possibility of securitizing a number of different assets under one type of security, we propose to begin with a disclosure regime that facilitates the securitization of one type of assets in a group.

It is worth noting that the American rules stipulate additional conditions in regard to securitized assets: for example, the American rules probe the subject of offering delinquent assets to the public, as part of the securitized assets, at the time of issuance. A delinquent asset, among other things, is an asset for which due payment was not received within a period of 30 days from the stipulated date of payment. Seemingly, delinquent assets can not be converted into cash within a fixed period of time, and therefore can not be subject to securitization. In fact, if the rate of delinquent assets at the time of public offering is substantial then it is not possible to see the offer as asset-backed; since the payments to bonds' holders are derived mainly from the ability of a servicer to collect cash contrary to the assets that are convertible into cash. According to the American rules the rate of delinquent assets is limited to 20%, in offers made according to a shelf prospectus and to 50% - in a regular prospectus.

Although the logic behind American and other rules is clear, it is not necessary to examine them at this point in time, before an asset-backed issue of bonds has been carried out in Israel. These matters should be addressed at a later stage, when a need arises,

C. **Disclosure within a Prospectus.**

It is reasonable to assume that in time a practice regarding disclosure of relevant details in a prospectus will develop, as it has developed in other prospectuses, and therefore there is now need to stipulate concrete requirements in advance. The guiding principal is that there is no need to fully describe all of the Originator's business associations, providing a full financial and legal separation exist between an SPE and an Originator and between the Originator and the sold assets. This guiding principal will be a major easement for any corporation, particularly a large one, planning to securitize its assets and to raise capital from the public.

We assume that main disclosures in a prospectus will relate to: securitized assets, parties to securitization and the structure of the securitization.

The description of assets offered for securitization should include – detailed description of assets, their characteristics (geographic spread, debtor's profile), criteria according to which the assets have been chosen and identity of whoever stipulated the criteria, risk factors related to the assets, to debiting or risk factors related to debt payoff to holders of securities, statistical information related to the performance of assets offered for securitization or to the performance of similar assets in the past, changes that might accrue in the asset group, etc.

The description of parties to securitization shall include – identities, qualifications and functions of an Originator, an SPE, a Servicer (primary and alternative), entities supplying credit support instruments and a trustee. Affiliations between the parties to securitization and the rights and obligations related to those affiliations.

The description of a securitization's structure shall include – explication of the nature of the proposed securitization, types of securities offered to the public and the distribution of the received cash flow among them, means of payment and means of cash collection from debtors and the transfer of money to an SPE, the means of holding the money by an SPE, models and assumptions for calculating the expected cash flow, commissions paid to various parties, the mechanism for replacing the Servicer, and description of risk factors related to the securitization in question (including risk factors stemming from judicial uncertainty). It is advisable to require a legal opinion to be attached to a prospectus, regarding the sale of assets to an SPE; in accordance with the regulations stipulated under paragraph 20(a)(3) of the Securities Law that empowers the ISA to require a lawyer's opinion regarding additional details beyond those stipulated under the Securities Regulations.

Following the standards stipulated under the Securities Law and the Securities Regulations – the substance and scope of disclosure are defined according to the essence and the circumstances of the matter, and will be stipulated according to each individual case.

D. **Rating requirements.**

The Bachar Committee had concluded that the condition for easements in disclosure requirements, related to a prospectus for public offer of the asset-backed bonds, is the acquisition of rating from a rating company; that due to the complexity of the financial instrument, the importance of a separation element in securitization and the experience that have been accumulated in private issues of securities.[56] The Committee had concluded that rating of the asset-backed bonds is a constant and important element and its usefulness to investors, considering the acquisition of the bonds, is very high. Nevertheless, at present, it is not necessary to stipulate the rating requirement as a condition for easements in disclosure requirements related to a prospectus. When the asset-backed bonds will be rated it should be done by taking into consideration both the backing assets and the separation between an Originator and an SPE.

7.3.2 Shelf Prospectus.

The advantages embodied in offering securities to the public, according to a shelf prospectus, are not singular to the issue of the asset-backed bonds. The publication of a shelf prospectus makes it easier for the companies offering securities, for long period of times, to base their offer on a general proposal stipulated in advance. The amendment to the Securities Law (amendment no.26) (shelf prospectus) 2004, with all the accompanying regulations, that was ratified by the Knesset – regulates this issue. According to the amendment of the Securities Regulations, (terms of offer according to a shelf prospectus) 2004, it will be possible to offer securities according to a shelf prospectus, in case the issuer is a reporting corporation and a period of at least 12 months had elapsed from its public offer of securities according to a prospectus, providing that a corporation had fulfilled all its reporting requirements and the court did not find the corporation or its corporate officers guilty of reporting violations, as stipulated under the aforesaid Regulations.

[56] see the Bachar Committee Report, p. 29-28

For this purpose, asset-backed bonds come under the definition of the "certificate of indebtedness", therefore the offer of asset-backed bonds may, under certain conditions, enjoy the privileges of a shelf prospectus offer. According to this conclusion the Committee thinks that some additional regulations are required regarding this matter.

7.3.3 Application Fee for the Permit to Publish a Prospectus.

In order to encourage the issue of mortgage-backed bonds and to facilitate those pioneer entities that will undergo incorporation to issue the aforesaid securities, and by taking into consideration additional costs pertaining the issue of this new instrument, we propose to exempt the issue of asset-backed bonds from the publication levy (aprx. 4,000 NIS and 0.03% of the raised capital) for a period of two years. To enact this proposal, amendment to the Securities Regulations will be required (request Fee for Application to Grant a Permit to Publish a Prospectus) 1995, (henceforth regulations Prospectus Regulations).

7.4 Current reporting of a corporation that issued asset-backed bonds.

Corporations reporting under the Securities Law are required to submit periodic reports as well as three interim reports every year. Details of these reports are stipulated under Securities (Periodic and Immediate Statements) Regulations. According to amendment no.23 of the Securities Law and Regulations, following the recommendations of the Barnea Committee, a periodic report should include description of the corporation's business, similar to the description required for a prospectus. Therefore, the scope of the aforesaid disclosure is also relevant for the periodic reports.

It seems that at present there is no need to stipulate special reporting requirements in regard to immediate reporting of corporations that have issued asset-backed securities. For example, according to Regulation no. 36 of the Securities Law and Regulations (Periodic and Immediate Statements) 1970, (henceforth - (Periodic and Immediate Statements Regulations), an SPE will be required to publish an immediate report regarding deals and transactions that deviate from the usual business of a corporation, such as: reexamination of its rating, downgrading of the rating, replacement of a Servicer and the reasons for his replacement, misgivings regarding the non-payment to bonds' holders, etc. The application of the above listed reporting requirements does not require a change in legislation.

7.5 Reporting of securitization by an Originator who is a reporting corporation.

According to the Securities Law, securitization by a reporting corporation is generally seen as a deal that deviates from the usual business of a corporation, and as such it requires immediate reporting, in accordance with paragraph 36 of the Periodic and Immediate Statements Regulations. A number of reports have been published, lately, by corporations that have carried out securitizations (as Originators), that ended in the private issuance of bonds. Those reports were limited in scope, and it is fitting for the ISA to publish a clarification regarding the details that have to be included in these reports.

We propose that an immediate report regarding securitization shall include the description of the deal, the identity of an SPE and the separation between it and the Originator, the backing assets and their means of sale, the return expected from the securitization, the designated aim for this return, Originator's debt (including debts taken on under the Servicing Agreement with an SPE) negative/positive exposure that an Originator might face due to the securitization (rising/falling of rating or complying with requirements raised by the debtor's of the Originator, etc.), and the rest of the deal's consequential implications (for example, a change in financial balance of an Originator).In case an Originator had issued bonds in the past, the securitization might require certification of the bonds' holders assembly and an appropriate reporting, according to the regulations stipulated at the time of bonds' issuing. During the securitization period immediate reporting, regarding replacement of a Servicer, receipt of substantial payments from the "security cushions" of an SPE, etc., will be required. The application of the above listed reporting requirements does not require a change in legislation, a clarification publish by the ISA is sufficient.

7.6 Rules of registration for trade on the stock exchange.

The stock exchange rules for registering bonds for trade stipulate that a new company or a trading company applying for registering bonds for trade has to comply with the following:

1. **Equity** of 16 million NIS or one of the following alternative:
   a. Local rating (A-) or international rating (BBB-) at least;
   b. Value of bonds issued in series – 200 million NIS
   c. For a company trading on the stock exchange: value of trading shares – 200 million NIS

2. **Value of a serie**s – 24 million NIS

3. **Minimal dispersions of public holdings** – 35 holders of bonds issued in series, while each one of them holds 200 thousand NIS.

These rules do not act as barriers for issuing asset-backed bonds; therefore the Committee did not find it necessary to amend existing rules of registration for issuing of bonds on the stock exchange, for the purpose of issuing asset-backed bonds.

7.7 Recommendations and Summary.

At present, nothing prevents the implementation of the disclosure standard formulated under the Securities Law for the purpose of issuing asset-backed bonds along the lines of the aforesaid proposal. We assume that in the future, after the development of a securitization market, a need will arise for more specific disclosure regulations.

We, hereby, propose that in order to qualify for significant disclosure easements, whose point is to avoid detailing all of the Originator's assets as well as to get exemption from fee payment for Application to Grant a Permit to Publish a Prospectus, the following will be required:

a Accounting Standard, valid at the time of securitization, recognizes derecognition of assets from the Originator's balance, all or in part, and the SPE reports are not amalgamated with those of the Originator.
b The Originator and an SPE are non-affiliated, with the exception of the securitization affiliation that might include a servicing agreement.
c The group of assets will be discrete and will include financial assets only.
d The existence of a management control system that insures the transfer of money to the SPE and their safekeeping for the benefit of bonds' holders.

An offer of asset-backed bonds that does not comply with the aforesaid requirements will be required to provide additional disclosure information regarding the Originator, and will not be exempt from paying the fee for Application to Grant a Permit to Publish a Prospectus.

We also propose:

a To publish guide lines regarding reporting on securitization for an Originator who is not a reporting corporation.
b To amend the Securities Regulations (Application to Grant a Permit to Publish a Prospectus) 1995, and to stipulate temporary provisions under which an exemption from fee payment for Application to Grant a Permit to Publish a Prospectus for an offer of mortgage-backed securities that comply with the aforesaid regulations, for a period of two years, in order to encourage the use of this financial instrument.

Chapter 8
8. Securitization of Government Projects

8.1 General

In the course of discussions held by this Committee an option of securitizing government projects has been examined. Nowadays, as was pointed out at the beginning of this report, the term "securitization" is applied to a growing number of various financial instruments where bonds are issued. What is common to all these instruments is that they are a means to raise capital at present - in return for cash flow expected in the future; cash flow that will be generated by assets or specifically defined groups of assets.

The subject of this report is the concept of securitization which states – it's possible to separate between a future cash flow expected to be received by a company and the rest of the company's assets, by selling the aforesaid cash flow. In this way the overall risk of a company is separated from the lower risk that is embodied in receiving a cash flow. On the other hand in the securitization of government projects, we are not talking about a "classic" securitization, where assets are transferred from an Originator to an SPE that issues securities, backed by those assets. In this case we are talking about the creation of a designated SPE, by the Originator who is raising capital for a specific, future project, which he himself will carry out. Remuneration of bonds is based of the cash flow from this project.

For example, a new company may seek to raise capital by means of a public or private issue for the purpose of establishing a tourist enterprise, it also stipulate that the issued securities are backed by the intake from this enterprise. This is in fact an issue of project related bonds. In this case, contrary to securitizations which are the subject of this report, there is no question of risk separation between the risk embodied in the project and other risks; provided that all the activities of the issuing company are summed up in this cash generating enterprise.

The issuance of bonds backed by a government project is in fact – an issue of project related bonds. Since in this case the Originator is a State the purpose of the issue is not to separate between a project related risk and the overall risks of the Originator, in order to reduce funding costs; here the aim of issuing securities is to address the public as a source of external funding for exceptionally large projects. In many cases the State executes large projects by means of private concessions (PFI/BOT Agreements), which are required to raise loans in the amount of 75% to 80% from the overall investment required in a project. They are hard pressed to raise these sums of money for reasons that are due to the size of projects, to restrictions placed on a sole borrower, or due to their capital adequacy; therefore there is a great deal of importance attached to acquiring additional sources of funding.

Government projects that are subject to securitization can be either active or future. For instance, a government may sponsor the construction of a toll highway by means of issuing bonds whose yield will be a function of the income collected from the highway. A similar issue can be carried out in regard to an existing toll highway, which already yields cash flow, and the return on the issue might be used for other government needs.

Securitization of government projects is customary in the West; it is carried out by both the State and the private sector that holds concession rights to government projects by virtue of BOT/PFI Agreements.
Issuance of securities backed by cash flow from governmental/municipal assets or projects is accompanied by a number of internal and external financial elements that act as "credit enhancement" to the issuing body. By using "credit enhancement" it is possible to upgrade the investment rating of issued securities. One of the elements is "mono-line" – insurance of bonds' remuneration (prime and interest) by means of singular insurance companies that deal only with this type of insurance (hence the term – "mono-line"). This insurance provides securities with high investment rating of the insurance company and increases the ability to issue securities; therefore we hope that the awareness regarding this instrument, on the Israeli market, will grow.

8.2 Singular characteristics of government securitization projects.

Main governmental projects that might be securitizes are in the field of transportation (toll highways, airports, public transport systems), although potentially there are other project as well, such as – desalination plants, power stations, etc. These projects usually have a positive cash flow from the date of completion and beginning of activation, for many years to come.

Securitization of government projects might be carried out by the government or by private entities that have received concessions to build and operate governmental projects in the field of infrastructure, for a defined period of time (PFI/BOT agreements). The securitization will be carried out according to the cash flow backing model, all or in part; cash flow expected to be received by the issuing body (the SPE), whose sole purpose is to establish and operate the project:

Singular characteristics of government securitization projects in the field of infrastructure:

a) By comparison to other projects common for the Israeli market, the cost of founding an infrastructure project is very high, in most cases we are taking about investment that is worth billions of NIS - a fact that creates difficulties in raising capital, particularly from the banking sector. The difficulties in raising capital in Israel are due to a limited number of large banks as well as to the limitations stipulated by the Bank of Israel regarding loans to a sole borrower or a group of borrowers, affiliated persons and minimal capital requirements.

b) Governmental projects are characterized by a long gestation period that lasts between two to six years; the project's cash flow during this period - is negative. That distinguishes them from mortgage-backed securitizations, cars leasing, etc., which produce a positive cash flow shortly after the signing of a basic mortgage-backed or car leasing securitizations agreement.

c) The overall field of operations is under governmental control, due to both judicial and agreement limitations; in some projects the State also acts as a client.

d) A large number of projects that run concurrently require funding. There are certain difficulties in raising foreign currency funds for these projects from foreign investors; in part they are due to the differences in the exchange rate – lack of compatibility between the currency used to fund a project and the currency in which an income from a project is received.

e) Investment in these projects by means of "Project Finance" carries high risks relative to the risks excepted in regard to bonds issued by a corporation, which is due to a high concentration of risk factors such as – the use of high leverage, focusing on a narrow business field, lack of business experience on the part of funding entities, the existence of a borrower that lack business history, Non Recourse loans, long term loans (for a period of 20-30 years), etc.

8.3 Advantages embodied in securitization of government projects.

The issue of securities, backed by cash flow from governmental projects, on the stock exchange will substantially widen the non-backing funding sources for these projects, reduce funding costs, and therefore will increase their feasibility:
First – the public can participate directly or via trust funds in the investment that is not accessible to it today.
Second – due to the capital market reform, it is expected that many public institutions will join in the financing of governmental infrastructure projects, due to their need to find additional investment possibilities as well as due to the fact that investment time

span of public institutions is compatible with the life span of governmental projects. The investment scope of public institutions is related to the negotiability of bonds and the high rating of investment itself, therefore the issue of securities, backed by cash flow from governmental projects on the stock exchange or their registration as part of the "institutional continuity" system of the stock exchange, will greatly contribute to the purchase of asset-backed bonds.

Third – participation of the public as well as that of the public institutions might lead foreign investors to join in the financing of governmental projects, in any case it will contribute to increased competition on the existing financing market and will reduce the financing costs of projects.

In conclusion we would like to point out that the option of issuing bonds by means of a shelf prospectus will facilitate fund raising for costly projects of long gestation periods, since at present there is difficulty in both raising these large funds and in temporary investing them, prior to their investment in the project. Issuing of bonds by means of a shelf prospectus will allow raising capital from time to time, according to investors' ability and project requirements.

8.4 Summary.

The option of securitizing government projects has been examined due to many advantages embodied in bonds backed by cash flow from these projects. No particular barriers, requiring special reorganization or alignment including amendments of laws have been pointed out to the Committee, in order to advance the issuance of bonds backed by cash flow from government projects. Other steps that might facilitate this development such as: launching of the "institutional continuity" system by the stock exchange or legislating additional regulations under the Securities Law regarding special track shelf prospectus, have been already carried out.

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Prof. Mordehai Avriel – Bank Hapoalim
Ms. Vered Olpiner-Sakal Lawyer, Accountant – Head of Real Estate Dept., Israel Tax Authority
Mr. Gil Oren, Lawyer – Igal Arnon and Partners
Ms. Miriam Ilani, Lawyer – Ministry of Justice
Mr. Erez Altit, Lawyer – Goldfarb, Levi, Eran and Partners
Mr. Yaron Ernest, Senior Credit Officer – Moody's Investors Services
Mr. Eli Ashraf Deputy CEO for Financing - Mahteshim-Agan Industries Ltd.
Dr. Shmuel Bornshteen, Lawyer – Gross, Halevy, Grinberg and Partners
Mr. Joshua Blitzki, Accountant – Tax Dept. Bank Hapoalim
Mr. Anar Berger, Lawyer – Kemikaliim le Israel Securities Authority
Mr. Shai Berger, Lawyer, Senior Manager VAT Dept. – Israel Tax Authority
Mr. Tzvika Bernsteen, Accountant – Professional Dept., Israel Tax Authority
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Mr. Zeev Golan – Manager of "Amitei Keren Korat"
Mr. Menahem Gorman, Lawyer – Samat, Shtainmats, Herring and Partners
Mr. Gil Gazit – General Manager (CEO) Midrug Ltd
Mr. Moshe Giltzer – Municipality of Tel-Aviv, Yafo
Mr. Ido Galil, Accountant – The office of Supervision of Banks
Ms. Aviva Dagan, Lawyer - Gross, Halevy, Grinberg and Partners
Ms. Ruti Dahan, Accountant - "Maalot" Israel Company for Securities Rating Ltd
Mr. Gil Doitsh - General Manager (CEO) "Akselnes" Investment House
Mr. Amir Levy, Lawyer - Gross, Halevy, Grinberg and Partners
Ms. Michal Hakar, Lawyer – Kaspi and Partners
Dr. Doron Herman, Lawyer – Friedman and Partners
Mr. Dani Vitan, Accountant – Someh-Haikin
Mr. Josef Zinger – Zinger-Even
Ms. Dalit Zamir, Lawyer – Ministry of Justice
Ms. Ronny Talmor, Lawyer - Ministry of Justice
Mr. Eli Yunes – CEO Bank Hamizrahi
Mr. Aya Yoffe, Lawyer - Gross, Halevy, Grinberg and Partners
Ms Davida Lahman-Messer, Lawyer – Deputy Legal Council, Ministry of Justice
Prof. Shalom Lerner
Dr. Israel Leshem, Lawyer – Meitar, Lekvernic, Geva and Partners
Ms. Hagit Meerovitch, Lawyer – Kantor and Partners
Mr. Moshe Mizrahi, Lawyer – Legal Council Israel Tax Authority
Mr. Shmuel Mansberg – Manager of Business Division, Bank Hamizrahi
Mr. Jack Matza, Accountant (Lawyer) – Senior Deputy for Professional Issues, Israel Tax Authority
Ms. Dorit Slinger – CEO "Maalot"
Mr. Menahem Ferd, Lawyer – Kaspi and Partners

Mr. Asher Fogel – Chairman "Ampa Investments"
Mr. Elai Peterman, Accountant (Lawyer) – Senior Dept. Manager, Israel Tax Authority
Mr. George Froidensteen - CEO EMI – Ezer Hevra Le Bituah Mashkantaot
Mr. Moshe Perets, Accountant – Kasselman & Kasselman
Ms. Vered Tzohar-Toaf, Lawyer – Legal Office, Bank Tfahot
Mr. Shlomi Kalsi – Risk Modules
Mr. Israel Kantor, Lawyer – Kantor and Partners
Ms. Michal Rabinivich, Lawyer – Legal Council, Leumi and Partners Investment House
Mr. Asher Rabinovich, Lawyer – Friedman and Partners
Mr. Gil Raveh, Lawyer – Herzog, Fuks, Neeman and Partners
Mr. Efrat Ram, Lawyer - Herzog, Fuks, Neeman and Partners
Mr. Shiri Shaham, Lawyer – Igal Arnon and Partners
Mr. Yaakov Shteinmetz, Lawyer – Samat, Shteinmetz, Herring and Partners
Ms. Yael Shidlovski – Manager Asset-Backed Securitization and Credit Dept. "Harel" Insurance
Mr. Moti Shelner – Risk Modules Ltd
Mr. Ran Shaked – Deputy Financial Director, New Kopel Ltd
Mr. Ofer Sharon, Lawyer – Legal Department, Israel Tax Authority
Trent Jonson Adv. – PWC, Washington

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