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Securitisation in Russia: an overview of the legal framework and recent developments

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In recent years Russian originators have demonstrated an increasing interest in securitisation. A number of transactions have been carried out in the market, which was established in mid-2005. Over 20 securitisations have been completed so far and a number of asset classes have been securitised, including car loans, residential mortgages, consumer receivables, railcar leasing receivables, diversified payment rights, credit card receivables and factoring trade receivables. Most of the securitisations have used cross-border structures and only three mortgage deals have been carried out domestically under Russian law on mortgage-backed securities.

Even without an ideal legal environment, the inherent advantages of securitisation in Russia, including access to cheaper capital, regulatory capital relief and diversification of funding sources, have prompted the emergence of the first transactions. The variety of asset classes that originators are willing to securitise is constantly growing and now includes various future-flow assets, mortgages, car loans, leasing receivables, consumer receivables, credit cards receivables, collateralised debt obligations, factoring and trade receivables.

Regulatory framework

At present, no specialised legislation exists in Russia for the securitisation of assets, apart from mortgages. Domestic mortgage securitisation is primarily regulated by Federal Law 152-FZ on Mortgage-Backed Securities (November 11 2003), which introduced certain novelties into Russian legislation. Apart from this law, securitisations fall within the general jurisdiction of Russian civil and finance laws, including:

- the Civil Code of the Russian Federation;
- Federal Law 17-FZ on Banks and Banking Activities (December 2 1990);
- Federal Law 39-FZ on the Securities Market (April 22 1996);
- Federal Law 127-FZ on Insolvency (Bankruptcy) (October 26 2002) and Federal Law 40-FZ on Insolvency (Bankruptcy) of Credit Organisations (February 25 1999);
- Federal Law 173-FZ on Currency Regulation and Currency Control (November 21 2003); and
- the Tax Code of the Russian Federation.

In March 2005 the International Financial Corporation Technical Working Group on Securitisation published its final report aimed at improving Russia's legal and regulatory environment to support the development of a securitisation market. The report discussed the legal environment in Russia and set out proposed amendments to Russian law to facilitate securitisation in Russia. Since 2005 various Russian legislative bodies and regulators, including the Russian Federal Service on Financial Markets (FSFM), have been working on a number of draft laws to amend the existing legislation in order to facilitate securitisation of assets in Russia. The proposed changes are intended to facilitate securitisation of various assets in both the domestic and international contexts, as well as generally to provide a more creditor-friendly environment for financing in Russia. Apart from domestic mortgage securitisation legislation, this is the first substantial attempt to establish a legal securitisation framework in Russia.

Finally, at the end of 2007 the Supreme Arbitration Court of the Russian Federation published Informational Letter 120—An Overview of the Practice of Application by Arbitration Courts of Chapter 24 of the Russian Civil Code (October 30 2007). Chapter 24 of the Civil Code regulates, among other things, assignments of receivables. The letter summarises court practice on various legal issues relating to the assignment of receivables, as well as the position of the Supreme Arbitration Court on such issues. Although the letter is not binding, as a matter of

practice Russian courts generally follow the position expressed by the Supreme Court in such letters. The letter touches upon certain legal issues relevant for securitisation deals (eg, identification issues, transfer of rights and obligations, assignment of bank loans to non-banking institutions, sale of future receivables) and is helpful in reducing some of the legal risks currently existing with Russian securitisations.

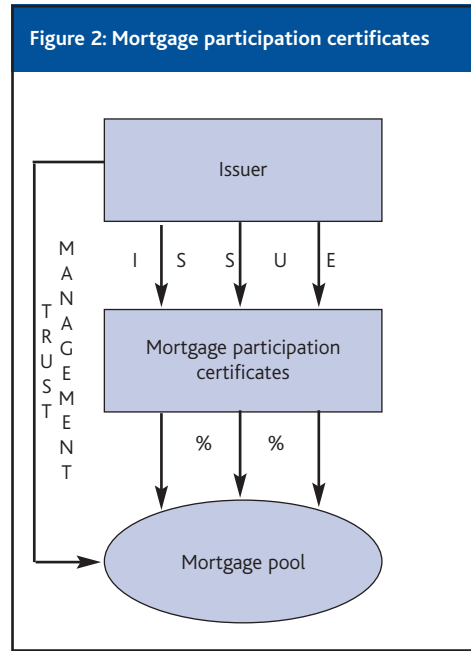
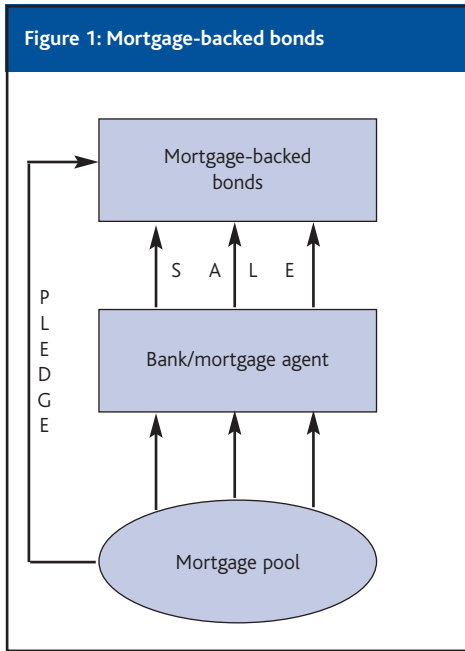
Mortgage-backed securities

The Mortgage-Backed Securities Law recognises two types of mortgage-backed securities:

- mortgage-backed bonds, which may be issued by banks and specialised mortgage agents; and
- mortgage participation certificates, which may be issued by banks and companies licensed to manage investment, unit investment and non-state pension funds.

Mortgage-backed bonds are debt securities secured by a mortgage pool. Having the status of issuable securities, they require registration with the FSFM. Mortgage-backed bonds may be issued in both documentary and non-documentary form.

Unlike mortgage-backed bonds, mortgage participation certificates have no nominal value. Being similar to a unit in a mutual fund, a mortgage participation certificate records the mortgage participation certificate holder's undivided right of ownership in the mortgage pool. The structure of mortgage participation certificates is built around the Russian concept of trust management, which, unlike common law trusts, does not entail the transfer of legal ownership. The purchase of a mortgage participation certificate triggers the acquisition of a share in the mortgage pool and the automatic conclusion of a Russian law trust management agreement with the issuer acting as a trustee (or trust manager) in relation to the mortgage pool. The trustee manages only the pool of assets, while the certificate holders retain joint ownership of the pool. Mortgage participation



certificates are registered securities and may be issued in non-documentary form only. Unlike mortgage-backed bonds, mortgage participation certificates do not have the status of issuable securities and do not require state registration with the FSFM.

Choice of foreign law in securitisations

Russian law generally permits the selection of foreign law to govern transactions with a foreign element (eg, a foreign party or assets located outside Russia), which is important for cross-border securitisations. Such choice of law is subject to the usual reservations relating to public policy and certain mandatory rules from which the parties cannot deviate.

In the absence of a governing law provision, the law applicable to each specific contract within the securitisation transaction will be the law of the country with which the relevant contract is most closely connected. The general presumption is that the contract is most closely connected with the country where the party whose performance is characteristic for the

contract (eg, the seller in the case of a purchase and sale contract, the lender in the case of a loan facility or the service provider in the case of a services contract) has its principal place of business.

The law applicable to the receivables to which the assignment relates (eg, loan facility, leasing contract, purchase and sale agreement) governs:

- the relationship between the special purpose vehicle (SPV) purchasing the receivables and the debtor;
- the assignability of the receivables;
- the conditions under which the SPV can invoke the assignment against the debtor; and
- the question of whether the debtor has properly discharged its obligations (as many receivables in Russia are governed by Russian law, this is a key question when structuring a securitisation).

Although a foreign law sale of domestic assets is possible in principle, a local law sale has a number of benefits. First, it simplifies the conflict of law analysis

and makes the enforcement quicker and less costly (eg, because foreign law need not be proven before a local court). This might have implications for any reserves that are built into the structure as credit enhancement. The sale documentation and the disclosure in the prospectus will also be more straightforward (eg, because there is no need to discuss the recognition of a foreign law sale in local courts or in the insolvency). A local law sale is also more clearly understood by the originator and other relevant parties and regulators (eg, in connection with any regulatory clearances, such as from the central bank or anti-monopoly authorities). Therefore, a properly structured local law sale of the assets would achieve the strongest true sale. The vast majority of cross-border securitisations in Russia have been structured as Russian law sales.

Types of asset suitable for securitisation

Russian law generally permits the transfer of receivables unless such receivables fall within a limited class of assets that are inseparably connected with the creditor's person (eg, compensation of harm caused to life or health). Both domestic (eg, loans, bonds, leases, credit card receivables, factoring receivables) and cross-border receivables (eg, export proceeds, diversified payment rights, licence fees) are capable of securitisation. Securitisation of cross-border receivables would generally provide for fewer restrictions and greater flexibility in structuring the transaction as the parties may subject certain transaction documents to foreign governing law.

To date, the concept of a mortgage pool, introduced by the Mortgage-Backed Securities Law, most clearly reflects a move towards international practice. Essentially, mortgage pools are pools of receivables secured by mortgages (ie, pledge of immovable property), as well as by a certain limited number of other types of asset, such as money, both in Russian roubles and in foreign currency, government securities and/or immovable property). Under the Mortgage-Backed Securities Law, mortgage pools are to be kept and maintained by specialised depositories licensed to conduct operations with investments, unit investments and non-state pension funds.

True sale

Under Russian law, receivables are generally transferred by way of assignment, which can be carried out by agreement of the parties or, in certain limited cases, by operation of law (eg, subrogation or substitution of a guarantor that has discharged a debt for the rights of the creditor).

As a transfer mechanism, the assignment is distinguished from the legal transaction underlying such transfer (eg, purchase and sale, swap, gift or security agreement). Accordingly, the transaction underlying the assignment may be a sale by the originator to the SPV, a swap or a transfer by way of capital contribution.

In addition, Russian law recognises factoring as a special mechanism for transferring certain types of receivable – namely, accounts receivable generated by the originator by delivering goods, rendering services or performing works for the benefit of a third party. The transfer mechanism in case of factoring is more securitisation-friendly as compared to a straightforward assignment. For example, an assignment by way of factoring cannot be prevented by a 'no assignment' clause contained in the underlying contract. Transfer of future receivables is expressly permitted by way of factoring.

In general, a true sale can be achieved under Russian law, provided that:

- the intention of the parties and the wording of the transaction documentation make it clear that the receivables are transferred by way of sale, rather than by way of security or otherwise; and
- the results of the transaction (including the discretion and the level of control afforded to the purchaser and the amount of recourse afforded to the originator) is consistent with the sale.

A failure to establish the proper structure for the transaction and put in place proper agreements documenting the sale of the receivables may result in the transfer of receivables being re-characterised by a Russian court as a secured loan, servicing agreement or an agency agreement.

Notice requirement

A transfer by way of assignment or by way of factoring is valid without regard to whether the relevant debtor has been given notice of the transfer. However, the purchaser bears the risk of any unfavourable consequences resulting from failure to give such notice. Until the notice is given, the debtor can discharge its debt to the assignor rather than to the assignee. In order for the assignee to assert a direct claim against the debtor, a written notice of assignment is required. For factoring transactions the law also provides that the notice should identify the assigned receivables, as well as the factor, to which the debtor is to make the respective payments. In practice, the debtor would generally be asked to acknowledge receipt of such assignment notice and undertake to make payments to the SPV in accordance with the terms and conditions of the underlying contract and of the relevant assignment.

Bankruptcy remoteness

In general, in a securitisation transaction the issuer of the asset-backed securities (the SPV) should be structured as a bankruptcy-remote entity – that is, there should be little or no risk of the SPV becoming subject to voluntary or involuntary insolvency proceedings. In addition, the insolvency of the originator should not contaminate and affect the activity of the SPV. The structure of a transaction should provide the means to ensure that assets are available to make interest and principal payments in a timely manner, notwithstanding the insolvency of the originator.

Before the enactment of the Mortgage-Backed Securities Law, the concept of a Russian SPV was virtually unknown in Russian legislation. At present, it may be problematic to set up a truly bankruptcy-remote domestic SPV and, therefore, the use of an offshore SPV is generally preferred. Although some foreign players are showing increasing interest, Russia still lacks a developed infrastructure for setting up and running domestic SPVs. However, following the examples of other countries including France, Italy, Spain and Greece, in the Mortgage-Backed Securities

Law the legislature has for the first time tried to create a special purpose securitisation vehicle – a specialised mortgage agent for domestic mortgage securitisations. A specialised mortgage agent may be incorporated only in the form of a joint stock company whose sole purpose is the acquisition of mortgage pools. Further, the constituent documents of the specialised mortgage agent should specify the number of issuances that such a specialised mortgage agent may undertake.

In a domestic mortgage participation certificate structure the holders of the mortgage participation certificates have joint ownership of the mortgage pool and hence, upon the insolvency of the originator, such pool is not included in the bankruptcy estate of the originator. More recently, changes to the insolvency legislation have been made to provide that mortgage pools backing the issue of mortgage-backed bonds should also be segregated and excluded from the bankruptcy estate of the issuer of mortgage-backed bonds.

Disclosure of information and data protection

Under Russian law, a bank is under an obligation to preserve bank secrecy – that is, the secrecy of accounts, deposits, client transactions and information on the clients. Such information may be provided to the clients themselves, their representatives and, in limited cases, public authorities. In addition, the Civil Code protects against the unauthorised disclosure of commercial secrets – that is, information that:

- has commercial value due to the fact that it is unknown to third parties;
- is not freely accessible; and
- is preserved as confidential by its owner.

Persons who wrongfully disclose banking and commercial secrets may be liable for penalties and damages and subject to criminal prosecution.

Arguably, limited disclosure of information on the agreements underlying the receivables should be permitted and disclosure of such information should not affect the validity of the receivables transfer. The

authority for this is derived from the provisions of the Civil Code requiring the originator to pass on to the SPV documents proving its rights to the receivables, as well as to disclose information that is relevant for exercise by the SPV of its rights under the assignment.

Russian law also has certain restrictions for the processing, disclosure and transfer (including cross-border transfer) of personal data, and in certain cases may require prior consent of an individual. It is therefore generally advisable to include in agreements documenting the securitised receivables (eg, loans, mortgages) a specific customer's consent for the disclosure of personal data to a purchaser of the receivables.

Tax implications

The tax implications arising in connection with a securitisation transaction under Russian law include those related to the withholding tax, value added tax (VAT) and corporate profits tax. Russian law imposes no stamp duty in connection with the sale of receivables to an SPV. The tax implications of a particular securitisation may also depend on the type of receivable, as well as on whether the transaction is cross-border or purely domestic.

Withholding tax

Any interest payable by Russian debtors to an offshore SPV having no permanent establishment in Russia is subject to a 20 per cent withholding tax. The SPV may, however, be exempt from the Russian withholding tax pursuant to a double tax treaty (currently there are more than 70 such treaties in force, including treaties with the United Kingdom, Luxembourg, Cyprus, the United States and Germany).

VAT

The sale of receivables is generally not subject to VAT under Russian law if the underlying transaction is VAT

exempt. For example, receivables relating to banking operations (eg, loans, deposits, settlements, bank guarantees) are generally exempt from VAT.

If the receivables are subject to VAT then the sale of the receivables may also be subject to VAT. The tax implications of this, however, can be mitigated, as was demonstrated in the Red Arrow Rail Car Leasing transaction, by offsetting VAT that is paid on the sale against VAT which is received together with the leasing payments.

Profits tax

The sale of receivables to an SPV for the purpose of securitisation will generally result in the receivables being discounted or sold at par – that is, the sale will not generate taxable profit for the originator. Otherwise, a 24 per cent profits tax is payable by the Russian originator on any positive difference between the balance-sheet value of the securitised receivables and the purchase price paid upon their assignment to the SPV.

Conclusion

Russian legislation, although giving rise to certain issues and risks, already provides for a basic regulatory framework of securitisation transactions. At present, many of the risks related to the existing regulatory gaps may be reduced by properly documenting and structuring transactions. A number of bottlenecks may also be removed at an early stage by revising underlying standard receivables documentation (eg, loan agreements, leasing contracts). Therefore, there is a greater need for the originators to ensure that the receivables are booked under securitisation-compliant standard documentation. Nevertheless, a specific legislative framework could further foster the growth of the market so that securitisation would become simpler, cheaper and easier than is possible under current legislation.