TRUE SALE AS AN EFFECTIVE MECHANISM TO MITIGATE THE RISK OF BANKRUPTCY IN BANKING SECURITIZATION OPERATIONS: THE ALGERIAN SECURITIZATION SYSTEM AS A MODEL

ABDERRAOUF HALOUADJI
University of Eloued, Algeria
halouadji-abderraouf@univ-eloued.dz

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Abstract

The paper aims to explore the extent to which true sale is realized in the procedures of mortgage loan securitization organized in Algeria according to Law 06-05. The concept of true sale relies on a set of criteria that render the securitization of mortgage loans a genuine sale of debts, leading to the complete transfer of debts from the ownership of lending banks to securitization institutions. This, in turn, results in mitigating the bankruptcy risk for any party involved in the securitization process.

***Keywords**: Securitization, Mortgage Loans, True Sale, Bankruptcy Risk, Bank Credit.*

Introduction

Securitization of loans is one of the innovations of modern financial engineering designed to provide mechanisms for banks to refinance themselves by transferring their loan-related debts to entities called securitization institutions. Banks usually face risks associated with the bankruptcy of the transferring or transferee institutions. Therefore, various systems have quickly put in place exceptional mechanisms in case of insolvency of the institutions involved in securitization operations. The Algerian legislator regulated securitization activity under Law 06-05, dated 20/02/2006, which established the legal provisions for organizing securitization procedures and the parties involved. Some systems, particularly the Anglo-Saxon ones, have introduced legal mechanisms to mitigate the risk of bankruptcy of one of the main parties in the securitization operations, especially the transferring institution, on the securitization process. These mechanisms rely on establishing exceptional legal rules that alleviate the harshness of ordinary bankruptcy rules on securitization parties.

However, this is often subject to the discretionary authority of the judiciary, making the commitment to a true sale the crucial mechanism to protect securitization operations from any inevitable effect of the transferring institution's bankruptcy on the securitization institution. In our study, we will examine the issue of the extent to which the Algerian securitization system adheres to conducting a true sale in the procedures of securitizing mortgage loans organized under Law 06-05. To answer this question, we will explore the concept of the obligation to conduct a true sale (first) and how it is realized according to the criteria of a true sale (second).

First: The Concept of the Obligation to Conduct a True Sale

The concept of conducting a true sale in the context of securitization operations refers to the complete financial separation between the transferring institution and the securitization institution in terms of legal structure independence and the full transfer of securitized assets from the transferring to the securitization institution.

In the Algerian mortgage loan securitization system, the Algerian law considers the securitization institution as a financial entity established in the form of a joint-stock company, meaning it has full independence. Therefore, it is believed that the Algerian legislator has adopted a system of separating the transferring institution from the securitization institution. The Algerian legislator did not organize the case of creating a bank or financial institution with a non-independent structure for securitizing its mortgage loans. Therefore, achieving a true sale in securitization operations subject to Law 06-05 is highly possible, where the transfer of right leads to the transferor losing its creditor status and the securitization institution acquiring the new creditor status. (1) The philosophy of securitization is based on the absolute exit of the right from the financial scope of the transferor, leading to the complete removal of any bankruptcy effect on those rights, which become the complete and clear property of the securitization institution unaffected by the transferring institution's bankruptcy. This is because there is no legal, financial, or accounting connection between them due to their separation as two independent legal entities from each other, as well as the complete transfer of the transferred assets to the securitization institution, thus preventing execution against them in favor of the transferring institution's creditors in case of bankruptcy.

Most legislations agree that declaring bankruptcy requires lifting the bankrupt's control, from the date of bankruptcy declaration (2), over all their properties and any properties acquired by them while in a state of bankruptcy. This situation is more sensitive and risky when the bankrupt is a bank or financial institution involved in securitization activities, especially as the transferring institution continues to manage the assets and collection operations, a direction prevalent in banking practice, which the Algerian legislator has adopted. (3) The securitization institution can entrust the transferring institution with the recovery of the mortgaged loans transferred and use lifting of control and all other tasks related to management on behalf of the securitization institution (4).

It should be noted that the Algerian legislator did not mandate the transferring institution to manage the assets, but the institution responsible for collection could be another entity, leaving this to the will of the securitization deal parties, unlike the Moroccan legislator who explicitly stated that the initiating institution continues to collect the revenues of the transferred debts. Banking practice has favored leaving the asset management task to the transferring institution (5). Therefore, isolating the fate of the transferring institution from the securitization institution must be confirmed by ensuring that the ownership of the mortgaged loans subject to securitization has actually transferred to the financial scope of the securitization institution, which is expressed in Anglo-American jurisprudence as a transfer constituting a true sale, regardless of the transfer method used, whether it is a right transfer, renewal, or sub-participation (6). The intended sale here is the one that results in the transfer of the sale subject and object from the domain of one person to another, regardless of the different terminologies used in various systems.

This sale should also steer clear of certain intentions or terms like accounting sale (7), or using terms or expressions suggesting an attempt to exacerbate the financial condition of the bank initiating securitization (the transferor) such as describing the transferred documents as premium bonds or any actions by the bankrupt debtor that grant privileges and competencies to creditors (8).

Second: Criteria for Considering the Assignment in Securitization Operations as a True Sale

These criteria are based on a set of indicators that confirm, deny, or diminish the intended goal, which is the transfer of all transferred assets from the transferring institution to the securitization institution. Some scholars, with the help of some judicial interpretations in the United States and legal interpretations in France (9), have attempted to establish some criteria, some of which the Algerian legislator has adopted. These criteria can be summarized as follows:

1- Recourse Level Standard

This standard refers to the extent to which a securitization entity can recourse to the assigning institution to fulfill its rights from the assigned loans and the interests they generate. The more frequent and varied these recourse instances are, the more it leads to the conviction that the securitization deal moves away from the true meaning of sale. Determining a level or form of recourse on the initiating bank after the deal's completion is crucial. If the recourse is an application of the general rules of buyer's recourse on the seller, then this does not remove the securitization operation from being a true sale (10). However, if the recourse exceeds this level, we are not in front of a true sale of assets, thus increasing the credit risks of the securitization operation. As long as the assets (subject of assignment) have not truly transferred to the securitization institution, the bankruptcy of the assigning institution will affect these assets, threatening the rights of bondholders.

Regarding the Algerian legislator, it did not address this issue in detail. Article 15, paragraph 02 of Law 06-05 is general and does not specify the level of recourse. It states that "the securitization institution replaces the assigning institution by law concerning the assigned loans and all forms of guarantees related to them from the date mentioned in the schedule referred to in Article 10."

Through this article, we understand that there is no recourse, meaning the transfer was complete; thus, the creditors of the assigning institution cannot claim the transferred rights, nor can the securitization institution recourse to the assigning institution (11). This is supported by the wording of the Algerian legislator at the beginning of Article 10 of Law 06-05, stating: "the securitization institution cannot purchase loans...", indicating the legislator's direction towards ensuring a true sale.

When investors enter a securitization deal by owning bonds issued by the securitization institution, their rights cover all assets of the securitization institution in addition to the mortgage loans obtained in the assignment by the assigning institution. It is clear that bondholders have the right to recourse to all assets of the securitization institution, as the legislator does not set limits on the extent of recourse as a right for bondholders. In our opinion, the legislator has adopted a strict approach in protecting bondholders by expanding their recourse to all assets of the securitization institution as stipulated in Article 06 of Law 06-05.

This approach, despite its positives in attracting investors to invest in securitization bonds, is seen as somewhat exaggerated by us, making all assets of the securitization company a guarantee for bondholders (12). On the other hand, the Algerian legislator did not address the rights of the securitization company's creditors, making it susceptible to the application of general guarantee rules, which is a gap that needs to be addressed (13).

Conversely, the Egyptian legislator was balanced, prohibiting securitization bondholders from having the right to recourse to all assets of the securitization company. Instead, their rights are limited to the securitization portfolio and its receivables and guarantees, in exchange for depriving the securitization company's creditors of the right to execute on the securitization portfolio, as it is not owned by the securitization company and does not fall under the general guarantee for its creditors. This makes us acknowledge that the Egyptian legislator has considered all scenarios, unlike the Algerian legislator, who left a gap that could open the field for recourse in securitization operations, affecting their stability and creditworthiness.

Despite noting this negative aspect in Algerian Law 06-05, we point out that Article 14, which specifies the basic data for the assignment schedule, indicates that the assigning institution commits to replacing doubtful or disputed loans or those difficult to collect for the benefit of the securitization institution. This means the Algerian legislator has provided solutions that obviate the need for recourse to the securitization institution and the assigning institution by replacing the initiating bank's assets that are delayed in fulfillment with other assets guaranteed fulfillment, a solution practiced in the American securitization system. The American Law Institute proposed obliging the initiating bank to guarantee that all assigned assets are flawless at the time of sale and will compensate for any damage to guarantees or commitments (14), which is practiced in Algerian law where the assigned loans must not be disputed or entail a risk of non-collection at the time of assignment (15). Similarly, Egyptian law stipulates that the assignor guarantees the existence of the assigned subject under the conditions stated at the time of assignment, allowing for a contrary agreement (16).

2- The Right of the Assigning Institution to Redemption

The right to redemption in this case means the possibility for the assigning institution to redeem the guarantees it provided to the securitization institution due to the mortgagor's (borrower's) right to redeem his secured properties in exchange, a right permitted by American laws (17). Based on this, if the initiating bank (assigning institution) agrees with the securitization institution on the right to redeem the real estate guarantees or to repurchase the delayed secured bonds, this action is closer to being a secured loan rather than a true sale in the context of the assignment in a securitization operation.

Regarding the Algerian legislator, we did not find any mention of this issue, nor can we definitively say that the redemption process is prohibited according to the mentioned concept, leaving room for interpretations that do not serve the stability and creditworthiness of the mortgage loan securitization system.

On the other hand, the French legislator recognized the danger of one of the securitization parties redeeming its rights, thereby prohibiting the transfer of assets with the right to enable redemption for the initiating bank, as well as prohibiting it from repurchasing the assets (18).

3- The Right to Surpluses

Surpluses refer to the interests and redemption proceeds that accrue to the securitization institution after liquidating the securitization portfolio. If the agreement states that these surpluses, after paying all due to securitization bondholders, belong to the securitization company without any right for the assigning institution, then this agreement is closer to a true sale than to a secured loan (19).

The Moroccan legislator did not conclusively address the issue of the surpluses, except for a non-decisive mention when specifying what the monthly report prepared by the custodian should contain (20).

Similarly, the Algerian legislator did not address this issue except for the general rule that confirms the entry of the assigned loans into the financial estate of the securitization institution once assigned by the assigning institution (21). Based on this ruling, we can say that the assigning institution's relationship with the loans it has assigned and all the interests they generate or those generated by the issued securitization bonds, even if their value increases, is severed. Thus, given this criterion, the assignment within a securitization operation in Algerian law is considered a true sale, which supports the creditworthiness of the securitization operation.

4- Securitization Bonds Pricing Mechanism Standard

This standard is based on the incentive driving the securitization institution to purchase mortgage loans, where the interests on mortgage loans are determined within a contractual framework between the loan-granting bank and the borrower. However, the loan-granting bank's assignment of its rights in them occurs at an interest rate lower than that agreed upon and specified in the loan contract, allowing the securitization institution to benefit from the margin between the lower interest rate and the bond issuance price to cover financing expenses and potential loss risks. Here, we face a true sale. If, however, the assignment's consideration is based on a variable interest rate, we are not in front of a true sale but rather an operation closer to a secured loan, like commercial loans (22). The Algerian legislator did not address this issue but left the freedom to the parties of the assignment within a securitization operation. Therefore, the assignment agreement must not include any reference to the issue of bond pricing or its variability rate for the securitization operation to be a safe, true sale.

5- Intent of Securitization Operation Parties Standard

The intent of the securitization operation parties must explicitly aim to conduct a securitization operation, and there should be no data suggesting otherwise. This standard is met in the legal system for mortgage loan securitization in Algeria, where the Algerian legislator has mandated that the assignment schedule contains clear data indicating the contract's designation as a contract for the assignment of mortgage-backed loans of the first rank and that the assignment of loans occurs based on the provisions of Law 06-05 related to the mortgage loan securitization system (23).

6- Management and Collection of Securitization Bonds Yields Standard

This standard is based on the consideration that management and collection activities are conducted for the benefit of the securitization institution if the assigning institution is tasked with the collection and management of yields (24). However, if it chooses to conduct these activities itself, this situation removes any suspicion related to distancing the securitization operation from the concept of a true sale (25), which is the natural order for the securitization institution to manage assets and collect yields. Yet, it may entrust the assigning institution with the task of managing interests and assets and collecting yields, provided that this is based on an agency contract clearly indicating that the assigning institution undertakes the collection and management task on behalf of the securitization institution. The Algerian legislator referred to this matter in Article 22 of Law 06-05 when it stated that the securitization institution could entrust the assigning institution or any other institution with the recovery of the mortgaged loans that have been assigned and their management as well as other tasks related to management on behalf of the securitization institution. The Moroccan legislator followed the same approach, allowing the initiating institution to continue under the supervision of the management institution in performing for the benefit of the Collective Investment in Securitization Fund (CISF) the collection of expenses resulting from the debts subject to the securitization operation, and deciding the fate of these recovered debts in an account opened at a credit institution for the benefit of the fund (26), where the creditors of the institution tasked with collection, whether the initiating institution or another, cannot claim these debts even in case of initiating judicial liquidation against it (27).

7- Mixing Collection Revenues with the Assigning Institution's Funds Standard

Considering that in most securitization operations, the assigning institution continues to manage the collection process of mortgage loan installments on behalf of the securitization institution, if an agreement on this continued management is included in the assignment agreement, it is necessary to segregate these funds as a deposit in a separate special account from other funds. To the extent that this account is independent of the bank's other accounts, the securitization is closer to a true sale that protects the securitization institution from the bankruptcy of the assigning institution and, consequently, protects all security holders, which is considered a protection for the entire securitization operation from credit risks.

Regarding the Algerian legislator, it did not refer to specific procedures for separating the installments due on the mortgaged loans that have been assigned, although it explicitly stated, as we have seen earlier, that mortgaged loans completely transfer to the financial estate of the securitization institution. It would have been preferable for the Algerian legislator to specify separation procedures to avoid mixing the balances of the assigning institution tasked with collection with the balances of the securitization institution, which could be achieved through amending Law 06-05 or by referring to regulations issued by the Bank of Algeria.

As for the Moroccan legislator, it recognized this important detail and stipulated the opening of a special account for the collected amounts at a credit institution (bank or financial institution), specifically earmarked for the collection yields for the benefit of the Mortgage Debt Securitization Fund (28).

Conclusion

In conclusion of this study, we record the following results and suggestions:

- The Algerian legislator expanded the scope of recourse to all assets of the securitization institution as stipulated in Article 06 of Law 06-05, and in doing so, was not balanced, exposing the securitization institution to pressures from the assigning institution. Thus, we suggest defining and limiting the scope of recourse within the value of the debts.
- The Algerian legislator did not clarify the limits of the redemption right, which refers to the possibility for the assigning institution to redeem the guarantees it provided to the securitization institution. Therefore, we suggest a precise definition of the value of the guarantees included in the redemption right.
- The Algerian legislator affirmed the complete transfer of the assigned loans to the financial estate of the securitization institution upon assignment, which makes the securitization procedures closer to a true sale and supports the creditworthiness of the securitization system in general.
- The Algerian legislator left the freedom for the parties involved in the securitization operation to determine how to price the bonds issued by the securitization institution, which realizes the idea of a true sale.
- The legal system for mortgage loan securitization in Algeria complies with the intent standard of the securitization operation parties, which must explicitly aim to conduct a securitization operation.
- The securitization institution manages and collects the yields of securitization bonds, and may entrust the assigning institution with this task for the benefit of the securitization institution by means of an agency contract, which confirms the availability of the true sale standard.
- There is nothing in the Algerian mortgage loan securitization system suggesting the mixing of collection revenues with the funds of the assigning institution, leading us to conclude the availability of the standard of not mixing collection revenues with the funds of the assigning institution as an important criterion among the true sale standards.

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16. Ola Hussein Ali, previous reference, p 19.
17. Typically, the assigning institution is a bank with expertise and knowledge in managing the collection process and is informed about the situation of the borrowing debtors.
18. Article 27 of Law 33-06, previous reference.
19. Article 31 of Law 33-06, previous reference.
20. Article 31 of Law 33-06, previous reference.