

Innovation Series
GLOBAL CORPORATE TRUST

Do You Have Change for a Tögrög?

How a trustee can help you navigate cultural differences and minimize risks when venturing into non-U.S. markets



THE BANK OF NEW YORK MELLON.



With structured finance expanding to more non-U.S. markets, Patrick Tadie of The Bank of New York Mellon explains the challenges and the role trustees play in managing the risks.

The developing niche economies within Europe, Asia-Pacific, and Latin America are increasingly the topic of conversation for investors. Many see opportunities in these markets for achieving greater gains in geographically diverse locations devoted to asset securitizations. Structured finance is roughly a \$4.1 trillion business, in terms of total securities issuance worldwide as of 2Q 2007. It has expanded rapidly over the last few years and will probably continue to grow as more non-U.S. markets open up and the regulatory environment in these countries gets more established. In the US, consecutive record-breaking quarters helped the first half of 2007 become the largest half on record. With US \$547.3 billion in proceeds, the first half of 2007, bested the previous record, set in 2006, by 12.4%. Internationally, proceeds from the securitized market rose by 78.8% compared to the first half of 2006.

But challenges await investors in a developing market. These include restrictions on the type of transactions an investor can make—cross-border or in-country—regulations that do not encourage the pooling of assets, a scarcity of transactions that can be converted to a securitization, unfriendly taxation, varying documentation, and reporting standards, foreign exchange restrictions, inadequate default procedures, and other market, operational, and political exposures that, when combined, heighten the risks that are normally a part of many international transactions.

Those who are interested in non-U.S. bonds would be better off working with a partner, such as a law firm or investment banker who, along with an experienced trustee, knows the local market and its nuances—

rather than venturing alone into an unfamiliar market. With the right qualifications, such a partner would be instrumental in helping these investors avoid the traps, as well as minimizing the risks which they are likely to meet. In contrast to a mature market such as the U.S., which in the early 1980s introduced modern securitization as we know it to the capital markets, local market trends tend to differ from a cultural, transactional, legal [ex: special purpose trust (SPT) versus special purpose vehicle (SPV) structures], and regulatory standpoint.

Regulatory Differences

Federal and state regulations governing securities transactions in the U.S. protect investors on different levels, which is often not the case in transactions involving a developing market. For example, under the U.S. Trust Indenture Act of 1939, securities may not be sold to the public without a trust indenture. This written agreement describes the terms of the transaction and the other issuer's obligations to the bondholders. It also dictates the trustee's actions on behalf of investors. Various governing bodies also oversee the securities industry in the U.S., such as the Securities and Exchange Commission (SEC), which has wide authority over industry practices, as well as the power to discipline those who break the rules.

Not so in many international markets, which often operate under local civil

Unlike many international markets, various governing bodies oversee the securities industry in the U.S. and have wide authority over industry practice, as well as the power to discipline rule breakers.

law jurisdiction (or a hybrid between the civil law as in Thailand), where only the security agent may be recognized in a domestic court of law. A trustee would then need to depend on local agents to represent it in the local jurisdiction. So doing business across different states or regions within an international market can be, but need not be, a costly and cumbersome affair. This is changing in countries such as Italy, Germany, Taiwan, and Mexico, among others, which have already taken steps to reform their laws and make them more securitization friendly. In Italy, for example, the Italian Securitization Law passed in 1999 establishes the rules and standards for securitizations in the local market. Meanwhile in Germany, the recently adopted True Sale Initiative (TSI) has paved the way for the German securitization market to continue to develop. Regulatory and tax hindrances that were formerly associated with the true sale of assets in Germany have been minimized or erased. The initiative also calls for development of a securitization platform, and an industry forum to promote and further develop the standards that encourage securitizations in the German market.



Transactional Differences/Similarities

MBS Transactions - Trustees in the U.S. typically provide document custody as a standard service on all mortgage-backed securities (MBS) transactions. But on some international deals, when such a service is provided at all, the job of holding the deal documents often falls to the issuer or originator, or some other designated authority.

CDO and ABS Deals - Transactions involving collateralized debt obligations (CDO) and asset-backed securities (ABS) tend to be similar throughout the world. CDOs are typically issued in multiple tranches in the U.S., whereas in some countries, particularly Asia, single-tranche issuance is quite common.

Project Finance and Secured Debt Offerings - In some markets, unlike the U.S., these transactions often call for different accounts to be set up, including multiple trusts and collateral agents. The tasks performed, as well as potential tax payments on deals that do not use local entities, also differ from the U.S. model.

Transaction Reporting - The level of detail that is required to be reported on different transactions often varies or is not as transparent as in the U.S. This is, however, changing since the main rating agencies, such as Standard & Poor's, Fitch, and Moody's, began setting reporting standards for international transactions. Meanwhile, reporting requirements and the frequency of reporting are said to be intensifying in a number of non-U.S. markets, where investors and issuers are now demanding much more detailed monthly and sometimes weekly reports.

The level of detail that is required to be reported on different transactions often varies or is not as transparent as in the U.S.

Cultural Differences

Whole segments of the population in some developing markets have never taken out a loan, used a credit card, or are aware they can make certain transactions that are common in the U.S. and other international locations. This is, of course, changing in the countries that are awakening to securitizations. In many countries, too, some practices are considered taboo. For example, in Islamic areas where the concept of interest payment goes against cultural beliefs, many international entities have worked with Islamic entities and borrowers to find solutions that not only work for the capital markets, but also ensure compliance with local cultural beliefs. This is just one of the nuances that an outsider might not be aware of, but needs to know to navigate the local economy successfully.

Other Distinctions

Those who go to a developing market to make transactions should also be aware of differences related to:

Terminology - Terms that are commonly a part of U.S. securitizations might be different in an international setting. For example, some countries do not have an established concept for what a trustee is or does, so occasionally an equivalent term that approximates the U.S. version can be seen, such as le trustee in France, and representative of the noteholder in Italy. In addition, courts in certain countries have been known to interpret recognized terms in an entirely different manner, which can create additional challenges. Furthermore, while the U.S. might refer to a 30-year mortgage, a non-U.S. market might talk about a 40- or 50-year mortgage, or something else entirely.

Transactions and Performance History - Some countries do not perform many credit card transactions, so that when such transactions are done, the expectations might be vastly different from those in the U.S. For example, there might not be much available in the way of a performance history for specific collateral, including credit card payments, mortgage payments, auto payments, and so on. In contrast, in the U.S. there is a substantial amount of history available on these types of transactions. For example, one could research different attributes—California loans with a term of 30 years, including interest rates—and pull up a wealth of data.

In-Country Versus Cross-Border Transactions - The concept of in-country versus cross-border transactions is an important distinction in many non-U.S. markets. In-country denotes a local transaction in which both the issuer and assets are regulated under the laws of the country, with the bond issue itself denominated in the local currency and cleared and sold locally. Investors can be located within or outside the country. The term cross-border describes transactions wherein a local issuer goes beyond the country's boundaries to sell bonds in the international capital markets; investors can be in, but are usually outside the country; governing law is outside the country; and denominations of the bonds can be in a currency other than the local one. Trustees who do not have a presence in the local market can only act on cross-border transactions. In addition, the functions performed in these markets might not be your classical trustee role, but something entirely different.

In many countries, some transactions and financial practices common in the U.S. are considered taboo.

Different Exposures

Currency Risk - Transactions done in various foreign currencies introduce a level of complexity that would normally not be present on a single-currency transaction. For example, if an issuer in Italy or Japan executes a transaction with issuance in yen, and investors are looking for a dollar-based investment, the question of foreign exchange or currency risk must be addressed. Some kind of mechanism, such as a swap or other currency hedging instrument, is typically employed to minimize the risks associated with currency values rising or falling.

Country or Sovereign Risk - In some instances, issues such as the country rating, repatriation of receivables, and provisions in transactions that could protect assets in case of instability must be taken into account; so, too, the possibility that local courts might not recognize the trustee, which can be an additional challenge.

Mexico

Mexican trusts generally have the same concept as trusts in the U.S., where the trust is an agreement to transfer property to a third party, who will hold the property interest on behalf of designated beneficiaries. The trustee in this regard administers all duties associated with the protection of the trust's covenants, and in the case of Mexico, the trust agreement pursuant to local Mexican law.

A trustee in Mexico is similarly charged with the surveillance of trust property but, as long as the trust is formed for a specific legal purpose, the activities performed under the trust can be diverse and so the trustee duties can be broad. It is critical for a trustee to understand local market practices for proper execution and agreement of the covenants.

What a trustee can do tends to shift depending on the market, but the role is, in principle, the same no matter where transactions take place.

In a service industry such as trustee administration, cultural sensitivity and accommodations for the local language and practices are critical to success.

Trustee Obligations - Under Mexican law, a trustee's obligations are to execute the terms of the agreement. Typical provisions would be that the trustee cannot resign without extreme cause and that, in this respect, court approval is required. The trustee cannot be a named beneficiary under the trust agreement. If a trust involves real property, there is an obligation to register the trust in the Registry of Public Property. A Mexican trustee must always be a financial institution, to perform the associated activities of operating and administering assets charged to the trust. Such a financial institution must have a distinct trust operation (rules are restrictive on commingling services), in which the ability to execute trust activities is duly authorized under Mexican law by way of the individuals, rather than the entity.

Cultural Aspects - Beyond the legal and regulatory climate, in a service industry such as trustee administration, cultural sensitivity, and accommodations for the local language and practices are critical to success. Working hours for the capital market's Mexican clientele typically extend beyond a traditional 40-hour workweek, and there is an implicit expectation that they are serviced in equal fashion. There is also additional emphasis placed on formalities when writing or engaging in meetings. Building personal relationships is the key to effective problem resolution and committing to a service provider in Mexico. Awareness of hierarchal protocols is important, and senior level contact is a contributing force to building a client's trust and confidence.

The Value a Trustee Brings

What a trustee can do tends to shift depending on the market, but the role is, in principle, the same no matter where transactions take place. The trustee aims to fulfill the terms of the transaction agreement and to protect the interests of bondholders in the event of a default. This might require an extraordinary effort on the trustee's part in an international market where the impact of a bankruptcy could be significant.

Whether it involves a transaction in a more established market or a developing market, trustees provide value through their ability to:

HOLD THE PLEDGED ASSETS ON BEHALF OF THE BENEFICIARIES

IDENTIFY ANY RISKS THAT MIGHT AFFECT THEIR ABILITY TO BRING ENFORCEMENT ACTIONS ON THE PART OF INVESTORS, OR TO APPOINT A THIRD PARTY TO DO SO

DEVELOP RELATIONSHIPS WITH THIRD-PARTY AGENTS IN THE LOCAL MARKET WHO CAN REPRESENT THEM

ENSURE SATISFACTION WITH THE LEGAL OPINIONS SURROUNDING A TRANSACTION IN THE LOCAL MARKET

PROVIDE A NUMBER OF FUNCTIONS, INCLUDING PAYING AGENCY, SECURITY AGENCY, COLLATERAL AGENCY, CASH MANAGEMENT, AND LISTING SERVICES



Guides for Intrepid Investors

Going to a new or developing international market holds the potential for both risk and opportunity, but investors and issuers need competent guidance. An experienced law firm or investment banker can help with managing the risks due to market, operational, and political differences. Such a partner, plus a knowledgeable trustee acting on behalf of investors, would need to know the local market well, including the rules and regulations governing various transactions, and the economic and cultural influences within the country. Until one is well acquainted with a market, one will not be aware of the nuances that can either make or break a transaction. Local representation is essential. Participants should learn as much as possible about the local market, how it works, and what is required from an operational standpoint as it relates to payments, interest, and principal issuance. They should know whether what they are proposing can be facilitated under local laws. Other considerations that might directly affect a trustee's ability to function effectively and with reasonable care on behalf of investors include know-your-client (KYC) and politically-exposed-person (PEP) issues. Regarding PEP issues, companies might be owned by several people who are based in different countries. Issuers and investors should review the risk ratings that are published for each international market by the rating agencies, and they should be prepared to draw the line if there is too much uncertainty.

Until one is well acquainted with a market, one will not be aware of the nuances that can either make or break a transaction. Local representation is essential.



Patrick Tadie is head of the Global Structured Finance Group, and is responsible for mortgage-backed securities, asset-backed securities, commercial MBS, special servicing, structured investment vehicles, and global analytics units within the Bank's Global Corporate Trust Division. He manages approximately 500 professionals around the globe. Patrick joined The Bank of New York in October 2003 as head of the mortgage-backed securities unit and was named head of the Global Structured Finance Group in December of the same year.

This article first appeared in *International Financial Law Review's The 2006 Guide to Structured Finance*.

For more information, please contact:

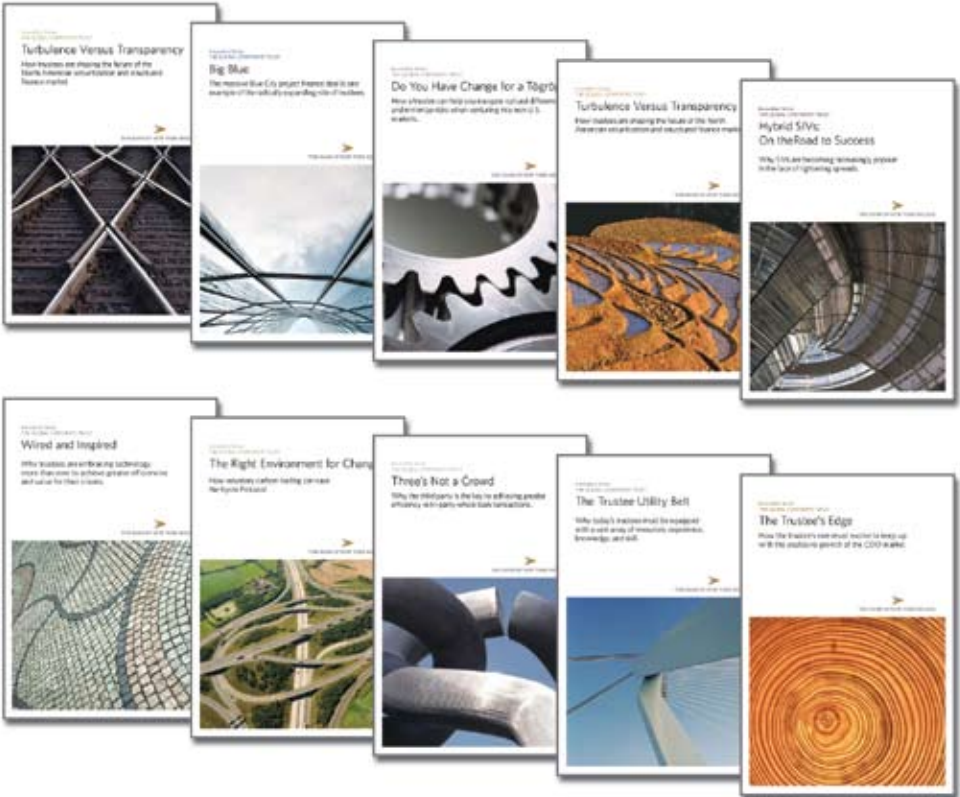
Patrick Tadie, Executive Vice President
Global Structured Finance
+1 212 815 2128
Email: ptadie@bankofny.com

Come see the future
of Global Corporate Trust.

Innovation Series

GLOBAL CORPORATE TRUST

Who's Helping You?



THE BANK OF NEW YORK MELLONSM

Cultural differences, ever-changing regulations, and transaction restrictions can make for some tough challenges for investors in non-U.S. markets. In this edition of the Global Corporate Trust Innovation Series, you'll learn the value in using a trustee when it comes to avoiding traps, minimizing risks, and investing successfully in non-U.S. markets.

Who's Helping You?



By Patrick Tadie



THE BANK OF NEW YORK MELLON.

The Bank of New York Mellon
Corporate Trust Publishing
www.bnycorpstrust.com/innovationseries