

Innovation Series
GLOBAL CORPORATE TRUST

The Trustee Utility Belt

Why today's trustees must be equipped with a vast array of resources, experience, knowledge, and skill



THE BANK OF NEW YORK MELLON.



Securitization continues to expand and extend its geographic reach, its usefulness, and its influence seemingly inexorably. This growth—in the volume and value of securitized issuance, in the global scope of the business, and in the potential complexity of transactions—makes the job of the trustee particularly important, and it makes doing the job right particularly challenging. When the trustee does get it right, the rewards can be substantial.



Just how big is the world of securitization? Underwriting volume in the global debt capital markets reached US\$4.1 trillion for the first half of 2007, compared to US\$3.6 trillion last year at this time—a 14% increase, according to Thompson’s Second-Quarter 2007 *Debt Capital Markets Review*. Deals in the emerging and high-yield markets led the advancers with double-digit gains. EMEA issuers saw the biggest gains, accounting for 41% of global volume, up from 39% last year at this time.

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.

What Is Making Securitization So Profoundly Significant a Financial Force?

First and foremost, securitization offers organizations—companies above all, but of course governments and public agencies, as well—more opportunity to raise capital and generate revenue, even as they transfer risk. It offers investors and issuers a new level of flexibility, such that the most sophisticated investment needs can be accommodated. It offers issuers the attractive side benefit of serving as an automatic monthly marketing tool, as investors track the issuer's reports on a regular basis. The bottom line: in an increasingly one-world capital market, securitization represents a flexible, accessible, attractive, and efficient means of financing.

But the benefits of securitization go well beyond the walls of financial institutions and the work of financial professionals. As the chairman of the U.S. Securities and Exchange Commission has noted, "every consumer in America depends on [securitization] and benefits from it." Speaking before the American Securitization Forum in June 2006, Chairman Christopher Cox asserted that securitization "holds the key to our nation's dreams," for the content of those dreams—homes, college educations, cars, and the like—are obtained almost entirely through loans, and "had they not been securitized, many of these loans could never have been extended in the first place."¹ The chairman's observation about American consumers is increasingly the case around the world, and as the demand for increased liquidity—and for lower costs of liquidity—becomes more and more imperative on a global basis, so too will securitization.

Trusteeship is key to the securitization equation—not solely because a trustee is a legal requirement in any debt security deal, but also to serve bondholder interests. Without the assurance of an independent party facilitating their payments and protecting their rights in case of default, investors would be less likely to enter the international debt capital markets at all. That makes the job of trusteeship as important to issuers as to investors. It also places enormous pressure on trustees.

¹ Speech by SEC Chairman: Remarks at the American Securitization Forum. Chairman Christopher Cox, U.S. Securities and Exchange Commission, Grand Hyatt Hotel, New York City, New York, June 7, 2006.



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Growing Complexity

The securitization proposition has come a long way since the 1970s, when the first mortgage-backed securities appeared as simple pass-throughs. Both the transactions themselves and the market environment in which the transactions proceed have become vastly more complex, and that has made the job of trusteeship vastly more challenging.

Back in the early days, a securitized transaction had but two classes, A and B. Cash came in from an issuer and went out to an investor on a date specified. The trustee's job—to act in a fiduciary capacity on behalf of the bondholder and facilitate payments to same—was relatively easy. That is no more.

Today, investors want to specify every single aspect of the characteristics of a bond—from accreted value to the terms of a Z-tranche. And they can. New techniques and new structures, especially in the high-yield market with its intercreditor arrangements and payment-in-kind (PIK) structures, have added to the complexity of transactions.

Perhaps above all, the multilingual, multicultural, multicurrency, and multijurisdictional aspects of doing business in a highly decentralized global capital market that lacks common exchanges intensify the transactional complexity and raise the bar on the challenge of doing the trusteeship job right.

Language and culture are perhaps the most obvious example of the complexities of working in a global market. Sometimes it's a question of defining terms. Say the word "mortgage" in the U.S., for example, and most people automatically think of a 30-year term. Say the word in Germany and you probably mean 10 or 20 years. The confusion can have costly results if you're securitizing a pool of mortgages.

Perhaps even more basic is the word "trustee," which has different meanings in different jurisdictions, many of which are now in the process of redefining the meaning. Moody's special report of 2004 on the model of the American trustee lit a fire under debt capital market participants

worldwide, and the review of trustee roles, obligations, and functions continues. The result is a varied and shifting global landscape when it comes to what a trustee can do, must do, and may not do—and added pressure on trustees everywhere.

“In-country” and “cross-border” are two more simple terms that can lead to complication and confusion. In many markets, an in-country transaction is one in which both the issuer and the assets are regulated by the same laws—the laws of that particular market—and in which the bond is denominated in the local currency and cleared and sold locally. The investors, however, can be anywhere.

Cross-border transactions, in those markets, take place when a local issuer goes outside the country’s borders to sell bonds in the international capital markets. The investors are typically outside the country; the governing law is outside the country; the bond denominations can be in any currency. Trustees who do not have a presence on the ground in this local market may generally service these cross-border transactions. It’s another instance where differences of understanding can make practice more burdensome.

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Practice and Regulation

Practices will also differ from market to market. On mortgage-backed securities, for example, it is typical for U.S. trustees to provide document custody on many transactions. Not so elsewhere in the international market, where an issuer, the originator, or some other designated authority is typically tasked to safeguard the mortgage documents.

On project finance and secured debt offerings, to give another example, some markets require setting up different accounts for multiple trusts and collateral agents—not the case in the U.S. Some markets tax deals that do not use local trustees. Some markets expect trustees to perform tasks that other markets will not allow them to perform. The bottom line: what is standard practice in one market may be untested at best, prohibited at worst, in another. Knowing the differences is essential to the task of trusteeship, since the trustee can be extremely important to the investor's interests.

Regulatory distinctions are perhaps the most formidable of differences, for governing rules and procedures are at the very heart of trust agreements. While countries like Italy, Germany, and Luxembourg in Europe, Taiwan in Asia, and Mexico in Latin America have begun to reform their securitization legislation, many countries still operate under local civil law jurisdiction. This means that to do business across those borders may require acting through a local agent, and that, in turn, could add not only to the complexity of the transaction but also to its cost.



Regulation, moreover, represents a constantly shifting environment, for it is the nature of regulators to constantly adjust the rules. Sometimes the changes can be substantive—as with the SEC’s Regulation AB in the U.S. and the international Basel II framework. Such changes can add disclosure requirements, and therefore more work and expense to the securitization transaction. And time may be needed, as is certainly the case with both Reg. AB and Basel II, for providers to fully work out the implementation of new rules, for investors to digest their impact, and for practices, vis-à-vis the rules, to be commonly integrated into the process.

Though at times difficult and frustrating, such regulatory changes are an inevitable fact of life in the international debt capital markets. No one would deny, for example, that in the wake of Enron and WorldCom, greater transactional transparency is both necessary and desirable. Investors want and need to know what’s happening with their bonds. Regulation is the answer to that, and while responding to an ever-changing regulatory environment may be difficult and awkward at times, it is an unavoidable reality any trustee must be fully prepared to handle.

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Risk

Always a challenge, risk exposure in today's international debt capital markets can add a particularly difficult level of complexity to the job of trusteeship. In some markets, sovereign risk can multiply overall risk exposure—notably in those countries where governments are unstable and where protection of assets and repatriation of receivables are realistic concerns. Currency risk is yet another wrinkle in the risk picture. Where multiple currencies are involved, transactions must often add mechanisms for hedging against the possibility of currency fluctuations, and in many deals, trustees must report on and monitor these complexities.



Today's Trustee: What It Takes to Get It Right

To be effective in this market, with its layers of complex challenges, today's trustee must be equipped with a full array of resources and must be prepared to use those resources at any time, anywhere. It is not an inconsiderable assignment, and it is not an easy job. Trusteeship takes not just the right resources but sufficient resources, and in the right configuration to be drawn upon, combined, offered, and delivered as, when, and where needed. At a minimum, this means the right people, the right systems, commitment, staying power, and of course, the kind of performance that both protects and adds value to client interests.

As always, people are the first essential. The task of trusteeship demands a staff of professionals representing a diversity of knowledge, expertise, and experience, along with native talent and skill. Diversity of work experiences is particularly important, first because so many skills are needed to meet the challenge of the job, and second because diversity creates the synergy that can stimulate the imaginative thinking the job requires.

That is why at The Bank of New York Mellon we have made it a point to gather corporate trust and structured finance professionals with backgrounds in rating agencies, investment banking, as issuers, as investors, in the legal profession, and in a range of other financial service companies. We believe such an ingathering provides the synergy that can best respond to the challenges of today's trusteeship.

A comprehensive systems infrastructure is the second essential tool for getting the trusteeship job right. Technology-based platforms for cash flow, bond payment, tax reporting, and for tickler systems that serve as checklists for every transaction every month of every quarter of every year constitute the bare minimum needed. Developing, maintaining, and consistently upgrading such an infrastructure represents a significant investment of resources.

Yet even more is required—specifically, risk management systems, since strategic risk management is a sine qua non of ensuring efficiency in the

capital markets and of maximizing revenue. Our approach at The Bank of New York Mellon has been to create a transaction compliance and risk management group that routinely monitors both the terms of the agreement and our actual performance. Any gap between undertaking and execution is instantly flagged for correction; the aim, of course, is that there be no daylight whatsoever between the terms of the bond agreement and our performance.

Another important aspect of our approach is our focus on KYC—know-your-client. For both prospects and, on an ongoing basis, clients we maintain an active process of background research, and these KYC procedures are clearly spelled out as part of the infrastructure.

This too, requires substantial resources, which is why the third essential for doing the trusteeship job right today is a strong commitment to the business from the financial institution in which the trustee operates. The commitment needs to be evident in the entire gamut of financial backing—capital, buildings, and compensation for those diversely experienced people, marketing materials, and the like.

The Bank of New York Mellon evidenced our commitment to the business most recently in our 2006 purchase of JPMorgan Chase's corporate trust business. As a result of the combination of our two strong businesses, The Bank of New York's Global Corporate Trust business now has US\$11 trillion in total debt outstanding for 90,000 clients, and over 3,500 employees in more than 50 cities around the world. That is a considerable commitment.

This expansion demonstrated more than just institutional commitment. Its timing, against a background of so many institutions dropping out of the corporate trust business, also evidences a staying power that is another essential element of doing the trusteeship job right. JPMorgan Chase is only the latest in a long line of major institutions that have opted out of providing debt security trusteeship services to clients. The departures of Wachovia, Bankers Trust, Harris Bank, and others may be seen as milestones in the consolidation of this industry, but for clients, each of these withdrawals has proven inconvenient and unsettling. It is inconvenient to have to start a relationship with your trust provider

all over again; it is unsettling to think that a fiduciary may not be here tomorrow.

That is not an issue for clients of The Bank of New York Mellon, which is not only the number one ranked trustee across practically all lines of business, but also the trust institution of greatest longevity in the U.S. With our 2006 acquisition, we gained yet more scale for reinvesting in the business and offered further ratification of our staying power.

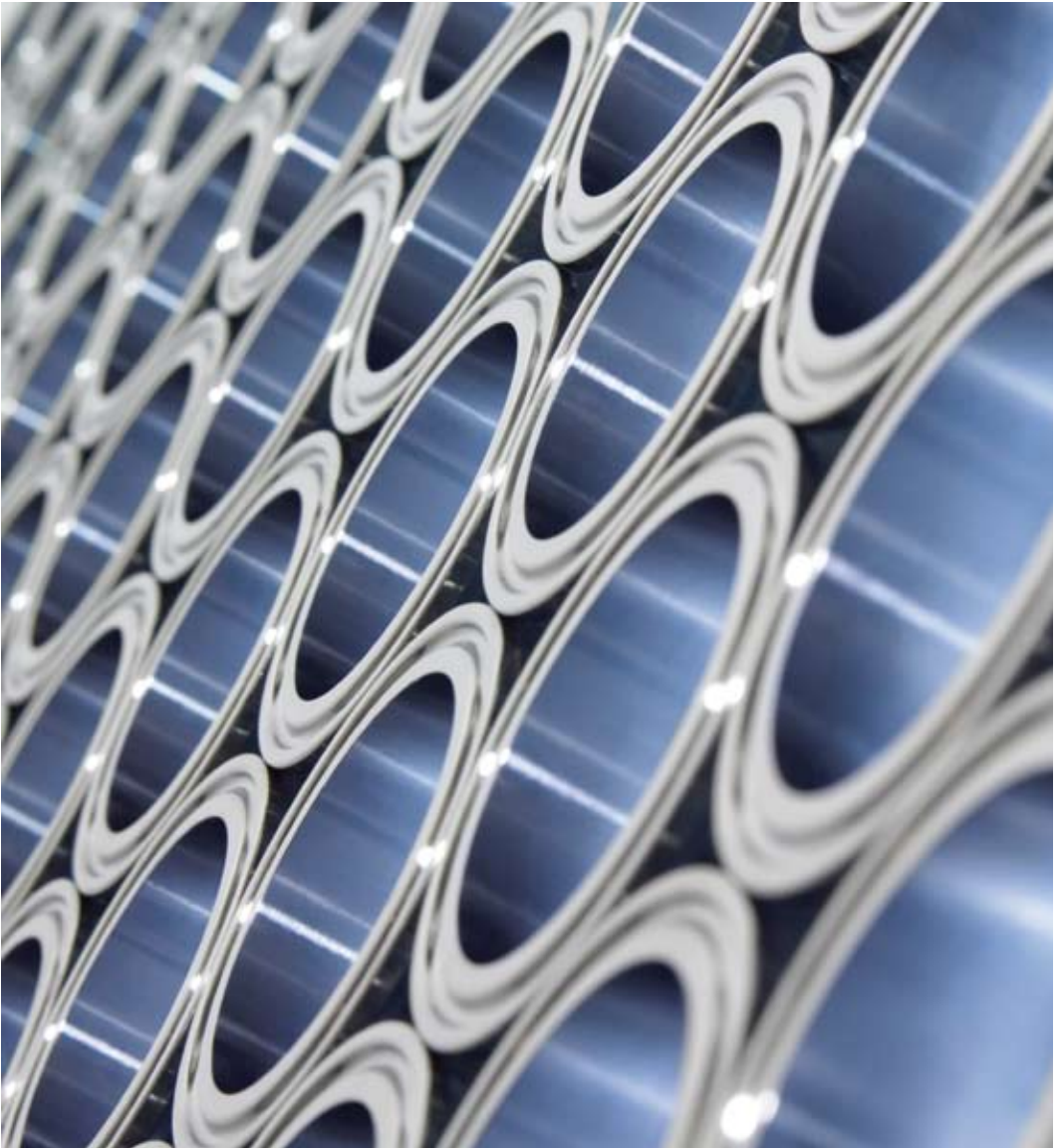
All of these requirements come together, finally, in the kind of performance that adds value on behalf of bondholders and earns both the rankings of rating agencies and the respect of peers, competitors, and investors, as well as of clients. Today's trustee is unlikely to achieve such performance without the people, systems, commitment, and staying power that are the prerequisites for getting it right.

Today's trustee must be equipped with a full array of resources and must be prepared to use those resources at any time, anywhere.

Conclusion

It is only going to become tougher and costlier to get the trusteeship job right in the future. As of this moment, vast new markets are being tapped in places like Russia, India, and, of course, China—markets of extraordinary opportunity. Still more opportunity exists in untapped markets where new governments or financial entities are just now able to issue debt. The complexities will grow, the challenges of geographic and cultural diversity will multiply, and the potential returns will be greater than ever. Trustees need to master getting it right today, if they are going to be able to reap the rewards of trusteeship tomorrow.

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James Maitland who joined The Bank of New York Mellon in 2006, is the Business Executive for our International Services' franchise in EMEA. As Regional Executive, James manages a portfolio of market-leading business lines which provide a full range of trustee, agency, and administration services across the debt capital markets. Prior to joining the Bank, James spent 18 years with JPMorgan in a variety of roles for the Corporate Trust, ADR, and Shareholder Services businesses. His responsibilities included business management, sales, product management, relationship management, and corporate development. James attended Vanderbilt University (BA degree, majoring in both economics and business administration) and New York University's Stern School of Business (Executive MBA program).

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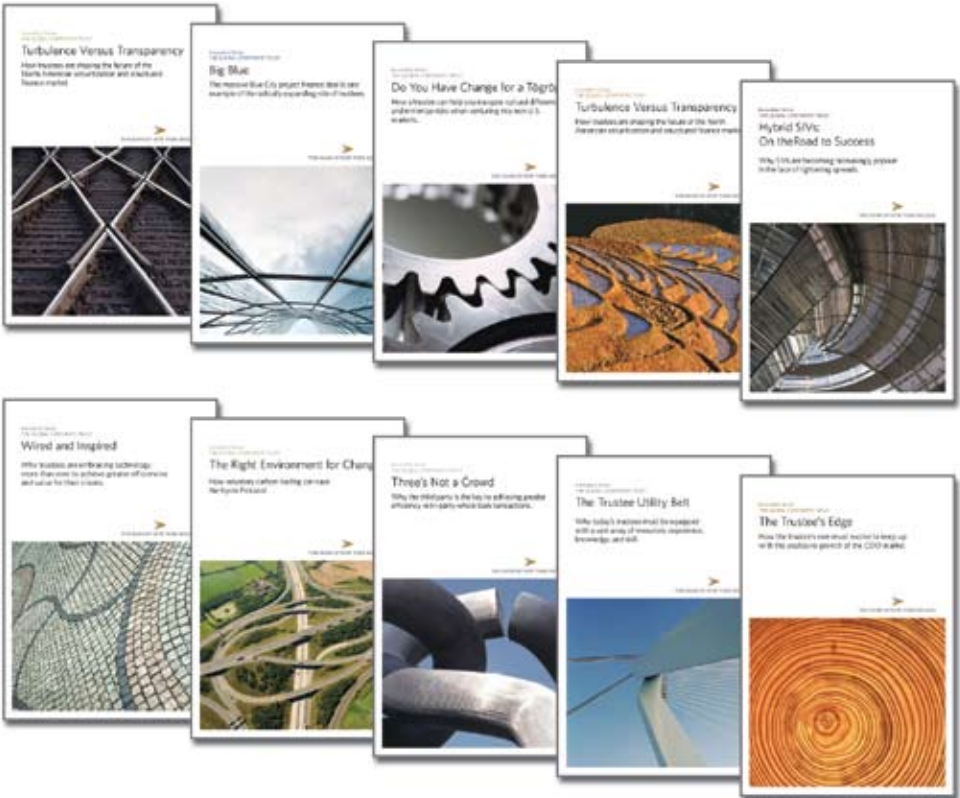
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Who's Helping You?



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As securitization continues to expand, so do its complexities. To meet new challenges, today's trustee must come equipped with vast resources, tools, and knowledge. In this article, you'll learn just what it takes for a trustee to be successful in the growing world of securitizations.

Who's Helping You?



By James Maitland



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