ABS/Emerging Markets
Criteria Report

# Legal Uncertainty in Emerging Market Transactions

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## ■ Background

Asset securitisation is becoming an important financing tool in many emerging markets. There are several challenges associated with the growth of this potentially dynamic market. Emerging market economies and financial systems tend to be more volatile than those in developed markets, while the quality of the business and regulatory and legal environment may also differ. Consequently, the performance of the underlying assets in an emerging market securitisation may be more adversely affected by macroeconomic volatility and global financial imbalances than in a developed market. The transaction is also at greater risk of systemic event risks such as political instability, government intervention or a failure of the legal system[1].

It is typical in asset securitisation that the credit quality of the assets being securitised is isolated from the credit quality of the seller of the assets by way of a true sale. By this means securitisation transactions can achieve ratings much higher than the seller; since its default would not have an impact on the credit quality of the asset backed securities per se. This explains why in developed countries transactions with sellers of sub-investment grade quality can often achieve 'AAA' ratings. In order to achieve this "de-linkage" it is essential that the true sale of the assets is enforceable in court even if an insolvency administrator of an insolvent seller challenges the true sale in order to maximise the bankruptcy estate for the benefit of the unsecured creditors. By contrast, in many emerging market countries the legal and political environment is such that despite a perfected true sale being confirmed in the transaction legal opinion, potential legal challenges to the true sale are much more severe, and will therefore often place limitations on the securitisation rating.

Many emerging market countries benefit from specific securitisation legislation, and have a strong and developed transaction history. Given these precedents it is usually the case that potential legal challenges to a true sale are limited. The presence of specific and detailed securitisation legislation helps guide the securitisation process and reduces the scope for either misinterpretation of transaction documentation or problems related to enforceability by the relevant legal authorities. However, where securitisation legislation and precedent does not exist, yet a true sale is carried out under the provisions of general law there might be more scope for legal challenge. Although the guidelines under the general law may in fact be relatively clear and transparent, they would typically be less robust and more open to interpretation than a developed securitisation law.

[1] For further background on systemic risks in emerging market securitisations readers are referred to *"Existing Asset Securitisation in Emerging Markets: Sovereign Constraints"*, dated 12 May 2006 and available at www.fitchratings.com

And while a true sale under general law provisions might work, in countries where the legal system is weak and opaque the enforceability and the interpretation of transaction documents may be less clear-cut. These systemic shortcomings are highlighted in a number of the legal opinions provided by transaction counsel. These can contain qualifications over enforceability and the interpretation of transaction documentation that relates to the true sale potentially leaving the assignment open to being overturned by a court judgement. This raises concerns over whether investors can rely on the isolation against the bankruptcy of the relevant seller and whether the transaction can be rated above the default rating of the seller (IDR).

## "True Sale" Challenge

In some ways, this type of legal qualification is not surprising given the novelty of securitisation in many emerging market countries, the lack of a concept of binding precedent in some of the legal systems, the potential lack of understanding of the securitisation concept and the possibility that courts and judges might be subject to political and economic influence. However, provided that the basic legal framework for a true sale or assignment is in place, and that the necessary legal steps to carry out and perfect the assignment have been taken, the scope for a successful challenge to the true sale should be reduced, notwithstanding the enforceability qualifications.

Depending on the severity of the enforceability qualifications set out in the legal opinion, it is unlikely that a successful challenge to the true sale would occur in all cases. Provided that the transfer was properly and legally perfected before this time, a challenge to the true sale would ultimately have to disregard or question the legal provisions that initially supported the assignment of assets. This suggests that it would in many cases have to stem from an insolvency administrator and/or a court decision that is either politically or economically influenced or has misinterpreted the legal provisions that surround the asset transfer. Even in a country where the legal system is weak and opaque such a scenario would not necessarily occur in all cases. And while a challenge may be mounted, it would not necessarily be successful 100% of the time.

Fitch assumes that any challenge to the true sale would take place upon default or insolvency of the relevant seller, it is important to note that in certain emerging market countries where legal uncertainties exist, the insolvency process will often be closely managed by an entity that might be able to add some additional transparency to the situation and ultimately act as a check on any arbitrary legal outcome that stems either from political or economic influence, or from a general misinterpretation of the transaction documentation. A typical sequence of events that could lead to the overthrow of a true sale is as follows:

1. Seller defaults
2. Seller is taken through the insolvency process
3. True sale is challenged
4. True sale is challenged successfully

## Challenge Factor

Given this series or process of events that might lead to a successful challenge to a true sale, it follows that the legal uncertainties with respect to emerging market true sale transactions are a nuanced rather than a binary issue and should therefore not restrict a securitisation rating to the IDR of the relevant seller. Rather, a successful challenge to a true sale is a subset of the IDR of a seller.

Fitch has therefore developed a "Challenge Factor" ("CF"), which is used to limit the number of notches that an emerging market securitisation can be raised above the IDR of the relevant seller in order to address the fact that even with a perfected true sale, transactions in emerging market countries may face the risk that the true sale is overthrown. The CF will essentially provide a measure of the quality of the legal and regulatory environment in which an assignment is made.

This does not mean that the transaction is no longer a full securitisation because the true sale is still supported by the relevant legislation of the country in question, and the CF will be applied to the IDR of a seller, recognising the notion that given enforceability issues and other concerns over transparency in some emerging markets, the default of the seller could trigger the above mentioned chain of events which might ultimately end in a successful challenge of the true sale.

The CF will be derived from a combination of factors, but chiefly the ranking of the relevant country against three key World Bank governance indicator scores relating to the 1) Rule of law, 2) Control of corruption and 3) Regulatory quality. The data, also used in Fitch's corporate debt country overlay, are available at www.worldbank.org/wbi/governance/govdata.

The World Bank report scores countries (209) on a scale of -2.5 to +2.5. These numbers have been adjusted to give a scoring range of 0–20 for each category and a weighted average is then calculated for each country. A 50% weighting is given to the Rule of Law indicator given that enforceability is such an important factor, a 30% weighting to the Corruption indicator and a 20% weighting to the Regulatory indicator. In addition to the score produced by the World Bank data, the analysis will take into account if the relevant country has securitisation legislation in place, if it has precedent of securitisation transactions, and the strength of the legal opinion produced by transaction counsel.

Depending on what score on the World Bank data a country achieves, a CF will be applied. This will range from CF1-4, with CF1 representing the strongest governance indicators and CF4 the weakest. A CF1 score would indicate that the maximum achievable rating of the transaction is not limited by the legal and political environment in the seller's country, although for an emerging market the transaction rating cap would be set at the country ceiling cap[2]. CF2 would imply a securitisation rating which can be up to 8 notches higher than the seller's IDR, although once again the transaction rating will be the lower of this "legal cap" and the country ceiling cap. CF3 will imply a maximum securitisation rating at the lower of 5 notches above the seller's IDR or the country ceiling cap. CF4 will indicate the challenge to the true sale is deemed so high that the transaction is effectively credit linked to the seller. The capping approach is set out below:

### Capping Approach

| Score | CF | Legal Cap |
|---|---|---|
| 15–20 | CF1 | No Cap |
| 10–14 | CF2 | Up to 8 Notches |
| 5–9 | CF3 | Up to 5 Notches |
| 0–4 | CF4 | Capped at IDR |

Source: Fitch

Where a country score places it in either CF2 or CF3, yet it has robust securitisation legislation in place, has a sound history of securitisation transactions and the legal opinion of transaction counsel and Fitch counsel is strong, the limitations will not apply. In effect, this will bring these countries into the CF1 category. The following table sets out the capping criteria for a number of key emerging market countries:

### Capping Criteria

| Country | Category |
|---|---|
| Argentina | CF1 |
| Brazil | CF1 |
| Bulgaria | CF2 |
| Chile | CF1 |
| China | CF3 |
| Croatia | CF2 |
| Czech Republic | CF2 |
| El Salvador | CF3 |
| Guatemala | CF3 |
| Hungary | CF2 |
| India | CF1 |
| Indonesia | CF3 |
| Kazakhstan | CF3 |
| Korea | CF1 |
| Malaysia | CF2 |
| Mexico | CF1 |
| Morocco | CF3 |
| Nigeria | CF4 |
| Panama | CF2 |
| Philippines | CF3 |
| Poland | CF2 |
| Romania | CF3 |
| Russia | CF3 |
| Saudi Arabia | CF3 |
| South Africa | CF1 |
| Thailand | CF2 |
| Tunisia | CF2 |
| Turkey | CF2 |
| Ukraine | CF3 |

Source: Fitch

Where a transaction includes the participation of a Multilateral Development Bank such as the European Bank for Reconstruction and Development (EBRD) or the IFC, and is structured in a manner where the originator transfers assets directly to the EBRD which then sells them on to the SPV, Fitch *may* give additional credit to the transaction rating based on the de facto 'preferred creditor status' of the MDB. This follows the same logic as MDB involvement as a means to mitigate transfer and convertibility risks. The argument is based on the argument that a MDB will have sufficient power and influence to ensure that it is treated fairly in any bankruptcy procedure. There is strong evidence that this has indeed been the case in certain emerging market countries[3].

[2] As per the Emerging Markets Existing Asset Criteria, Fitch will typically apply a maximum cap of 0-4 notches above the country ceiling rating of any emerging market, irrespective of the strength of the underlying asset performance. This is due to the increased probability of systemic and to some extent unpredictable "event" risks occurring at a stress level well beyond that of a sovereign default that could ultimately prove fatal to a securitisation transaction.

[3] For further details, please see 'The role of Multilaterals in structured finance' dated March 2006 and available at www.fitchratings.com