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Talking Points for Panel 2: New Products and Processes Mortgage-Backed Securities (MBS)

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Table of Contents

INTRODUCTION

This report was produced in response to a request made by the MFA Chairman in February 2007. The report presents talking points and background information for the Panel 2 discussion titled “New Products and Processes” that took place during the 18th IOSCO AMERC Conference held in Sharm El Sheikh on February 22, 2007. The focus of this paper was on Mortgage-Backed Securities.

MORTGAGE-BACKED SECURITIES

1. Basic Concepts

Securitization: The process of creating a financial instrument by combining other financial assets and then marketing them to investors. A securitization portfolio has financial rights assigned as backing (collateral), in favor of bondholders.

The financial rights available to bondholders include:

- Cash flow from the payments due under the assets from the debtors (contract receivables);
- Any related collateral rights (movable or immovable property pledged under the contracts);
- Recourse to the debtors directly in the event of default, under the terms of the contracts;
- The margin, or “over-collateralization,” protects investors against delinquencies in the securitization portfolio.

Asset-Backed Securities (ABS): A financial security backed by a loan, lease, or receivables, against assets other than real estate and mortgage-backed securities. For investors, asset-backed securities are an alternative to investing in corporate debt.

An ABS is essentially the same thing as a mortgage-backed security, except that the securities it backs are assets such as loans, leases, credit card debt, a company's receivables, royalties, etc., and not mortgage-based securities.

Mortgage: A debt instrument, secured by the collateral of specified real estate property, that the borrower is obliged to pay back with a predetermined set of payments. Mortgages are also known as liens against property, or claims on property.

Mortgage-Backed Securities (MBS): A type of asset-backed security which is secured by a mortgage, or a collection of mortgages. It is an investment instrument representing ownership of an undivided interest in a group of mortgages. Principal and interest from the individual mortgages are used to pay investors principal and interest on the MBS, also known as "mortgage pass-through".

When you invest in a mortgage-backed security, you are lending money to a homebuyer. MBSs are a way for lenders to give mortgages to their customers, where instead, the lender acts as an intermediary between the homebuyer and the investment markets.

Commercial Mortgage-Backed Securities (CMBS): Similar to a mortgage-backed security, but secured by loans with commercial property instead of residential property.

2. History of Securitization

In the mid-1900s banks were essentially portfolio lenders; they held loans until they matured or paid off. These loans were funded principally by deposits, and sometimes by debt, which was a direct obligation of the bank (rather than a claim on specific assets).

After World War II, depository institutions simply could not keep pace with the rising demand for housing credit. Banks, as well as other financial intermediaries sensing a market opportunity, sought ways of increasing the sources of mortgage funding. To attract investors, investment bankers eventually developed an investment vehicle that isolated defined mortgage pools, segmented the credit risk, and structured the cash flows from the underlying loans. Although it took several years to develop efficient mortgage securitization structures, loan originators quickly realized the process was readily transferable to other types of loans as well.

In February 1970, the U.S. Department of Housing and Urban Development created a transaction using a mortgage-backed security. The Government National Mortgage Association (GNMA or Ginnie Mae) sold securities backed by a portfolio of mortgage loans.

To facilitate the securitization of non-mortgage assets, businesses substituted private credit enhancements. First, they over-collateralized pools of assets, and shortly thereafter, they improved third-party and structural enhancements.

In 1985, securitization techniques that had been developed in the mortgage market were applied for the first time to a class of non-mortgage assets — automobile loans. A pool of assets, second only to mortgages in volume, automobile loans were a good match for structured finance; their maturities, considerably shorter than those of mortgages, made the timing of cash flows more predictable, and their long statistical histories of performance gave investors confidence.

In 1986, the first significant bank credit card sale came to market with a private placement of USD 50 million of outstanding bank card loans. This transaction demonstrated to investors that, if the yields were high enough, loan pools could support asset sales with higher expected losses and administrative costs than was true within the mortgage market. Sales of this type — with no contractual obligation by the seller to provide recourse — allowed banks to receive sales treatment for accounting and regulatory purposes (easing balance sheet and capital constraints), while at the same time allowing them to retain origination and servicing fees. After the success of this initial transaction, investors grew to accept credit card receivables as collateral, and banks developed structures to normalize the cash flows.

As estimated by the Bond Market Association, in the United States, in nominal terms, during the period 1995-2004, ABS outstanding amount has grown about 19 percent annually, with mortgage-related debt and corporate debt each growing at about 9 percent.

At the end of 2004, the larger sectors of this market are:

- home equity-backed securities (25 percent)
- credit card-backed securities (21 percent)
- collateralized debt obligations (15 percent)
- automobile-backed securities (13 percent).

Among the other market segments are student loan-backed securities (6 percent), equipment leases (4 percent), manufactured housing (2 percent), small business loans (such as loans to convenience stores and gas stations), and aircraft leases.

In Europe, total securitized bonds were:

- 1998: EUR 38 billion

- 2000: EUR   82 billion
- 2003: EUR 217 billion

2004: EUR 250 billion (= about USD 312 billion)

Securitization is now growing rapidly in emerging markets, such as in Eastern Europe, thanks to new laws that are now in place.

3. Why Securitize?

Advantages from Issuer's View of Securitization:

- Reduces Funding Costs: Through securitization, a company rated BB, but with AAA worthy cash flow, would be able to borrow at, possibly, AAA rates. This is due to the strength of the underlying collateral, and other credit enhancements.
- Reduces Asset/Liability Mismatch: Depending on the structure chosen, securitization can offer perfectly matched funding by eliminating funding exposure in terms of both duration and pricing basis.
- Lower Capital Requirements: Some firms have a limit or range that their leverage is allowed to be, due to legal, regulatory, or other reasons. By securitizing some of their assets, which qualify as a sale for accounting purposes, these firms will be able to lessen the equity on their balance sheets while maintaining the "earning power" of the asset.
- Locking In Profits: For a given block of business, the total profits have not yet emerged and thus remain uncertain. Once the block has been securitized, the level of profits has now been locked in for that company, thus the risk of profit not emerging, or the benefit of super-profits, has now been passed on.
- Transfer Risks: Credit, Liquidity, Prepayment, Reinvestment, Asset Concentration: Securitization makes it possible to transfer risks from an entity that does not want to bear it, to one that does. Similarly, by securitizing a block of business (thereby locking in a degree of profits), the company has effectively freed up its balance to go out and write more profitable business.
- Off-Balance Sheet: This term implies having no balance sheet impact.
- Liquidity: Future cash flows may simply be balance sheet items which currently are not available for spending, whereas once the book has been securitized, the cash would be available for immediate spending or investment.

Advantages from Investors View of Securitization:

- Opportunity to potentially earn a higher rate of return.
- Invest in a specific pool of high quality credit-enhanced assets.
- Portfolio diversification.

4. Reasons for Issuing Mortgage-Backed Securities

There are many reasons for mortgage originators to finance their activities by issuing mortgage-backed securities. Mortgage-backed securities:

- transform relatively illiquid, individual, financial assets into liquid and tradable capital market instruments;
- allow mortgage originators to replenish their funds, which can then be used for additional origination activities;
- are frequently a more efficient and lower-cost source of financing in comparison with other bank and capital markets financing alternatives;
- allow issuers to diversify their financing sources, by offering alternatives to more traditional forms of debt and equity financing;
- allow issuers to remove assets from their balance sheet, which can help to improve various financial ratios, utilize capital more efficiently and achieve compliance with risk-based capital standards;
- can be used by banks to monetize the credit spread between the origination of an underlying mortgage (private market transaction) and the yield demanded by bond investors through bond issuance (typically, a public market transaction).

5. Risks Associated with Mortgage-Backed Securities

Pricing a corporate bond is based on two sources of uncertainty: default risk (credit risk), and **interest rate** (IR) exposure. The MBS adds a third risk: early redemption (**prepayment**). In residential MBS securitizations, the number of homeowners who prepay goes up when interest rates go down, because they can refinance at a lower fixed interest rate.

Prepayment Risk: Prepayment is classified as a *risk* for the MBS investor despite the fact that they receive the money, because it tends to occur when floating rates drop and the fixed income of the bond would be more valuable (negative convexity). Hence the term: *prepayment risk*.

There are other drivers of the prepayment function (or prepayment risk), independent of the interest rate, for instance:

- Economic growth, which is correlated with increased turnover in the housing market.
- Inflation of the price of homes.
- Unemployment.
- Regulatory risk: if borrowing requirements or tax laws in a country change, this can affect the market profoundly.
- Demographic trends and a shifting risk aversion profile, which can make fixed rate mortgages relatively more or less attractive.
- To compensate investors for the prepayment risk associated with these bonds, they trade at a spread to government bonds. This is referred to as an “Option Adjusted Spread.”

Credit Risk*:* The credit risk of mortgage-backed securities depends on the likelihood of the borrower paying the promised cash flows (principal and interest) on time. The credit rating of MBS is fairly high because:

- The mortgage originator will generally research the mortgage takers ability to repay, and will try to lend only to the credit worthy.
- Some MBS issuers, such as Fannie Mae, Freddie Mac, and Ginnie Mae in the U.S.A., guarantee against homeowner default risk. The issuer's guarantee is itself

considered very solid because it is considered to be implicitly guaranteed by the U.S. Federal Government.

- Pooling many mortgages with similar default probabilities creates a bond with a much lower probability of total default, in which no homeowners are able to make their payments. Although the risk neutral credit spreads is theoretically identical between a mortgage ensemble and the average mortgage within it, the chance of catastrophic loss is reduced.
- If the property owner should default, the property remains as collateral. Although real estate prices can move below the value of the original loan, this increases the solidity of the payment guarantees and deters borrower default.
- If the MBS was not underwritten by the original real estate and the issuer's guarantee, the rating of the bonds would be very much lower, because borrowers with improving credit ratings would opt out of their mortgage to refinance at a lower credit risk; however those with deteriorating credit ratings would not.

6. Types of Mortgage-Backed Securities

Mortgage-backed security sub-types include:

Pass-Through Mortgage-Backed Security - the simplest MBS. Essentially, a securitization of the mortgage payments to the mortgage originators. These can be subdivided into:

- **Residential Mortgage-Backed Security** (**RMBS**) - a pass-through MBS backed by mortgages on **residential** property.
- **Commercial Mortgage-Backed Security** (**CMBS**) - a pass-through MBS backed by mortgages on **commercial** property.

Collateralized Mortgage Obligation (**CMO**) - a more complex MBS in which the mortgages are ordered into trenches by quality (such as repayment time), with each trench sold as a separate security.

Stripped Mortgage-Backed Securities (**SMBS**) - where each mortgage payment is partly used to pay the loan's principal and partly used to pay the interest on it. These two components can be separated to create SMBSs, of which there are two sub-types:

- **Interest-Only Stripped Mortgage-Backed Securities** (**IO**) - a bond with cash flows backed by the interest component of the property owner's mortgage payments.
- **Principal-Only Stripped Mortgage-Backed Securities** (**PO**) - a bond with cash flows backed by the principal repayment component of the property owner's mortgage payments.

7. Who Pools these Mortgages Together?

7.1 The European Model

In Europe, there exists a type of asset-backed bonds called **"covered bonds"** (commonly known by the German term Pfandbriefe). Pfandbriefe were first created in 19th century Germany when Frankfurter Hypo began issuing mortgage covered bonds. The market has been regulated since the creation of a law governing the securities in Germany in 1900. The key difference between Pfandbriefe and mortgage-backed or asset-backed securities is that banks that make loans and package them into Pfandbriefe keep those loans on their books. This means that when a company with mortgage assets on its books issues the covered bond, its balance sheet grows, which it would not do if it issued an MBS, although it may still guarantee the securities payments.

7.2 U.S. Models

The majority of MBSs are issued and backed by government sponsored corporations such as:

- the Government National Mortgage Association (Ginnie Mae)
- Federal Home Loan Mortgage Corporation (Freddie Mac)
- the Federal National Mortgage Association (Fannie Mae)

Each entity offers a slightly different variation in the securities it issues. Ginnie Mae MBSs are typically the most popular and widely held because they are backed by the U.S. Government, whereas Fannie Mae is government sponsored but also trades as a public company.

	GNMA	**Fed Home Loan Bank**	**Fannie – Freddie**
Type of support	Guarantees lender bonds (pool insurance)	Loans refinanced	Loans purchased
LTV	Up to 100%		Above 80%
Source of funds	Fees	Sell bonds*	Sell bonds*
Lender balance sheet	Mortgages off	Mortgages on	Mortgages off

* *Includes pass-through certificates.*

Strengths of MBS:

- Mortgage-backed securities are primarily used to provide *safe income*.
- There is also the opportunity to get some *capital appreciation* as interest rates fall.
- MBSs are traded actively, much like bonds are, so there is very *little liquidity risk*.
- Furthermore, they are considered an extremely *safe investment*, often said to have the same credit-worthiness as treasuries, but with a return that is 1-2% greater.

Volume of MBS Market in the U.S.A.:

Total market value of all outstanding U.S. MBS at the end of the first quarter of 2006 was approximately USD 6.1 trillion, according to the Bond Market Association. This is much larger than the market value of outstanding asset-backed securities. The MBS market overtook the market for U.S. Treasury notes and bonds in 2000.

According to the Bond Market Association, gross U.S. issuance of agency MBS was:

- 2005: USD 967 billion
- 2004: USD 1,019 billion
- 2003: USD 2,131 billion
- 2002: USD 1,444 billion
- 2001: USD 1,093 billion

7.3 The Egyptian Model – Egyptian Mortgage Refinancing Company (EMRC)

EMRC is the major source of liquidity for primary mortgage lenders.

EMRC Mission*:* EMRC is a specialized financial institution that provides refinancing to primary mortgage lenders through raising funds in the capital markets.

Funding: The refinance activity will be funded through a capital of 217 million, authorized (1 billion), and a low cost loan (WB loan). Another source of funding is the issuance of mortgage-backed securities.

Benefits of EMRC:

- EMRC will act as the industry maker, as it is the first resort of funds and liquidity for primary mortgage lenders.
- Low cost of finance to primary lenders will lower their cost of funding mortgage lending activities; this will eventually reduce mortgage interest rates for the consumer.
- EMRC will set the minimum quality standards for the new mortgage market by identifying its requirements.
- EMRC will enable qualified mortgage lenders to access long-term refinancing for their mortgage loans.
- Better management of the risks of mortgage lending.
- Increase the flow of private sector funding to the housing finance sector.
- Eventually increase lenders' capacity to finance more loans.

Primary and Secondary Markets Regulators:

- EMRC will be regulated by the Mortgage Finance Authority (MFA) when operating in the primary market as the liquidity facility (refinance activities).
- The Capital Market Authority (CMA) will oversee EMRC bond issuance.

Secondary Market Legal Framework (Securitization):

- Amendments to the Capital Market Law, Number 95, of 1992 - Articles (41) 1 through 8.
- Amendments to the Executive Regulations Articles, Chapter 10.
- All provisions applying to public bond issues also apply fully to securitized bonds.
- Legal and regulatory framework makes the issuance of securitized bonds possible by:
    - a securitization company to which an originator sells the securitization portfolio;
    - an originator as the issuer.

Comparison	Corporate Bonds	Securitized Bonds
Issuing Company	Joint stock company specialized in one or more business activity.	Specialized joint stock company with securitization as its sole activity.
Objective of Company	Secure medium or long-term funding for any of its business activities.	Financial mediator for transferring portfolios of financial rights (and relevant collaterals) into medium and long-term bonds, and providing the proceeds to the originators.
Source of Repayment of Interest and Principal	Cash flows generated from the company's activities.	Cash flows generated from the transferred financial rights.
Collaterals to Bondholders	General or specific guarantee on company's assets.	Financial rights portfolio and relevant collaterals.
Credit Rating	For company or the issue or the guarantor.	For portfolio or issued bond (not for the issuing company).

Coordination between the Primary and Secondary Markets Regulators:

- MFA sets risk-based regulations to EMRC, mandating certain standards on operation.
- Abiding to regulations, EMRC sets its own lending/buying portfolios minimum quality standards to primary lenders to minimize its risk.
- EMRC good portfolios when securitized will be at a low risk enhancing (insuring) the bond where by consequence will be safe for the bond holder.
- CMA regulations to the secondary market ensure safe market to the issuer as well as the bondholder.

Securitization Benefits:

Benefits to the **Economy**:

- Broadening of financial markets.
- New instruments for investors.
- Mobilization of capital for productive uses.
- New financial tool for issuers to tap capital markets.
- Funding sources for banks and other credit originators.

Benefits for **Issuers**:

- Provides access to capital markets not tied to credit rating of originator.
- Provides liquidity, converting illiquid assets to cash.
- Diversify funding sources and investor base.
- Raises capital to generate additional assets.
- Matches assets and liabilities to minimize risk.

Benefits for **Investors**:

- New investment instrument in market with potentially attractive yield.
- Source of cash to repay the bond obligations is very clear and can be monitored monthly by investors.
- Permits investors to select asset type in which to invest, permitting investor to select a bond with the desired asset type and to understand the risk profile of the bond (standardized).
- Strong role of custodian in reporting the collection process, ensuring bond payment on due dates.
- Margin between value of securitized assets and bond obligations protects investor.

Principal Players

- Originator (Assignor): gives assets to, receives cash from, Issuer.
- Issuer (Securitization Company):
    - joint-stock company with sole corporate object of conducting securitization ("special purpose vehicle");
    - minimum capital L.E. 5 million;
    - must be licensed by CMA;
    - issues securitized bonds backed by securitization portfolio;
    - uses proceeds from issuance of bonds to pay assignor for securitization portfolio;
    - gives securities (bonds) to, receives cash from, Investor.
- Investor (Bondholders): pay cash for bonds, receive cash from portfolio.
- Custodian:
    - receives all documents and information related to the securitization portfolio upon its assignment to the bond;
    - receives all funds collected by the servicer from the securitization portfolio;
    - pays bond interest and principal to the bondholders on due dates;
    - invests any surplus funds in treasury bills or bank deposits;
    - maintains books, records, and accounts on the securitization portfolio, which may be inspected by the representative of the bondholders;
    - submits detailed monthly reports on the securitization portfolio and collections;
    - ensures the effectiveness of the collection process on behalf of the bondholders.

Key Other Entities

- Capital Market Authority:
    - enforces procedures and reporting requirements;
    - ensures timely and complete monthly reports from custodian about securitization portfolio are submitted to bondholders or their representative;
    - ensures the required credit ratings of portfolio and bonds are performed annually, while the bonds are outstanding;
    - ensures the functioning of bondholders assembly and the existence of a representative of bondholders to enforce bondholders' rights;
    - ensures laws and regulations relating to a public securities offering are followed.

- The Servicer (Collector):
  - collects the financial rights under the securitization portfolio as agent;
  - pays all funds collected to the custodian;
  - takes all needed collection action, including foreclose on collateral, if a debtor does not pay;
  - may be the originator (assignor) or may be another entity;
  - the custodian monitors the performance of the servicer.

- Credit Rating Agency:
  - must be licensed by the CMA;
  - performs credit rating of the securitization portfolio (which has also been audited by the external auditor) and of the bonds;
  - the credit rating level determines the margin ("over collateralization") appropriate to the bond issue in relation to the cash flow from the securitization portfolio;
  - will rate the securitization portfolio annually during the life of the bond.

Asset-backed Securities Issued in Egypt to Date:

Issuer	Volume	Type of Asset	Date
Contact Cars	EGP 140 million	Cars loans portfolios	2006
Egyptian Arab Land Bank	EGP 500 million	Housing loans to developers	2006
Contact Cars	EGP 159 million	Cars loans portfolios	2006

Annex 1: Background on Securitization Developments in the Egyptian Market

- ***Regulatory Framework to securitization:***
  - Chapter 10 of executive regulations by Minister's decree number 46/2001 on November 11, 2004
  - Amendments to chapter 10 by Minister's decree number 138/2006 on April 29, 2006

- ***Securitization Company:***
  - Joint-stock company with sole corporate object of conducting securitization ("special purpose vehicle")
  - Minimum capital L.E. 5 million
  - Must be licensed by CMA
  - Issues securitized bonds backed by securitization portfolio

- ***The financial rights available to bondholders include:***
  - Cash flow from the payments due under the assets from the debtors (contract receivables)
  - Any related collateral rights (movable or immovable property pledged under the contracts)
  - Recourse to the debtors directly in event of default, under the terms of the contracts.
  - The margin, or "over-collateralization", protects investors against delinquencies in the Securitization Portfolio.

- **Additional detailed points - optional:**
  - Interest rate on securitized bonds is usually lower than interest rate on mortgage loans in the securitization portfolio. Hence, the mortgage lender will make earnings out form the spread between interest rate on bonds and interest rate on mortgage loans. In rare cases, interest rate on a securitized bond may be higher than the interest rate on mortgage loans.
  - In such case, the originator has to securitize a portfolio with a face and present values much higher than the bond face value to compensate for the deficit in return on portfolio compare to interest payment on bond.
  - This could happen when the originator has a low-return portfolio which can be liquidated through securitization and the originator expects to reinvest the proceeds in a new investment or a new portfolio with rate of return higher than that is paid on the bond. It is exactly the case of the Egyptian Arab Land Bank Bond.

- **Issues to date in the Egyptian Market**
  - **Contact Company for Securitization**, the special purpose vehicle (SPV), is offering 1.4 million bonds, with a 5 year tenor and a fixed coupon of 11% payable monthly. The issue is callable at any time during its life in addition to being amortized monthly.

Contact for securitization is 81% owned by the Egyptian International Trade and Investment Company, 18% by Contact for Car Trading, 1% Bavarian Contact for Car Trading. Contact for
Car Trading will act as a service agent (for collection of car loans) not as a paying agent to bondholders which will be Commercial International Bank (the custodian) and Misr for Clearing, Central Depository and Registry (MCDR) (the registrar).

The issue is rated AA by local Moody's affiliate MERIS.

- **Egyptian Arab Real Estate Bank** issued securitized mortgage bonds for the value of EGP500 million. The portfolio was guaranteed by the Ministry of Finance and thus the securitization portfolio was rated AAA by MERIS.

- **Contact Securitization Company, the 1st securitization company in Egypt,** published in November 2006 a prospectus for public offering of its 2nd securitization bond with the following main terms:
  - The face amount of the bond is LE 159 million;
  - Secured by a portfolio of car loans amounting to LE 202 Million with a present value of LE 169 million;
  - Over collateralization of LE 10 million or 6.45%;
  - Credit rating of the portfolio is "AA -";
  - Credit rating of the bond is "AA";
  - Interest rate on the bond is 10.75% payable monthly;
  - The bond is for five years with monthly redemption.

  This issue would make total securitized bonds issued to date **LE 799 million in 3 bond issues**.

- **A fourth bond issue** is expected in the 1st quarter of 2007 for LE 500 million for a portfolio of real estate loans to a developer.

- *Bank Misr's securitization issue of credit cards was done abroad (in US); not in the Egyptian market.*

Annex 2: Identifying the Securitization Portfolio

- The originator identifies a securitization portfolio it is willing to sell to a securitization company.
- Detail about the portfolio to be described:
  - terms and conditions of the portfolio assets
  - schedule of principal and interest payments (cash flow forecast for the portfolio)
  - collateral backing the financial assets
  - legal structure of the asset transactions
  - performance characteristics and history of the portfolio
  - risk characteristics of the portfolio.
- Information must be for aggregate data and for each specific financial assets or categories.
- Investors in a securitized bond are entitled to first priority claim on all proceeds of the securitization portfolio, the portfolio assets, and any underlying collateral, regardless of any claims on, or the insolvency or bankruptcy of the issuer or the originator.
- All proceeds from collection of financial rights from the securitization portfolio must be paid into an account controlled by the custodian.
- The custodian will pay all bond obligations from this account (deducting only the fees and commissions set forth in the prospectus).
- The custodian will invest any surplus in the collection account only in treasury bills or deposits with licensed banks, in the manner agreed with the issuer and as set forth in the prospectus.
- Any surplus in the collection account belongs to the issuer or the originator after the final obligations, under the securitized bond issue, have been paid in full to the bondholders:
  - the custodian maintains full control of the collection account until the bond obligations are repaid in full.
- The originator must provide to the custodian (through the issuer) all details and documents on each of the securitized portfolio assets and the obligors (borrowers) of each:
  - the custodian will provide the collector the information and documents needed for collection purposes.
- If the originator assigns (sells) the securitization portfolio to a securitization company, these assets will no longer be carried on the originator's financial statements as of the moment such assignment is valid (a "true sale").
- If the originator is the issuer of the securitized bonds, the securitization portfolio will remain in its financial statements as assets, and the securitized bond obligation will be a liability.