

POLAND
**SECURITIZATION OF
MUNICIPAL DEBT**

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POLAND

SECURITIZATION OF MUNICIPAL DEBT

Our mission was to make an assessment of the viability of the development of a securitized municipal debt instrument in Poland with a view towards establishing a market for longer-term capital. In accordance with USAID's agreement with the Association of Polish Banks we reviewed the overall legal and financial environment for securitized debt instruments as well as the viability of a pilot project based on the municipal loan portfolio of BISE bank.

We reviewed various existing papers and research reports relevant to the issue of a securitized municipal debt product in Poland and interviewed the sources listed in Appendix A hereto and in Appendix I to the Preliminary Report of June 1999, attached hereto as Appendix B (the "Preliminary Report") to determine an implementation strategy. Our approach was to make this assessment utilizing the following analytical format:

- The legal and regulatory environment for securitization
- The compatibility of the BISE portfolio with a securitization product
- The potential structure for the securitization product
- The investor demand for a securitization product

The Preliminary Report analyzed the legal and financial environment for securitization as well as raised certain issues and questions to be determined by BISE. On September 28, Mr. Wieslaw Sendek responded in writing to our inquiries, which was followed up with a meeting with Mr. Sendek on September 29. Based on these responses, additional meetings with the sources listed in Appendix A hereto and the conclusions reached in the Preliminary Report, we conclude the following.

THE LOAN PORTFOLIO

- The issues identified in the Preliminary Report relating to the transferability of loans made by Banks to local governments remain substantial obstacles to the development of a securitized product utilizing loans as the "asset" to be securitized. For example the following issues, *inter alia*, remain:
 - The confidentiality of information relating to the loans that is imposed by the Banking Law, which at a minimum would require a waiver from each local government.
 - The inability of the issuer to subrogate to the rights of the lending bank to enforce the contractual provisions of the loans due to the limitation on the

enforcement of remedies by any party other than the originating lender;
and

- The legal right of a borrower to “offset” any claims (even if completely unrelated to the loan transaction) it has against the originating bank by reducing the amount of its loan payments by the amount of such claims.
- The lack of homogeneity in the structure of the Bank’s portfolio, including non-uniformity of documentation, contractual provisions specific to particular loans which may prohibit their transfer or enforceability by other parties, and primarily variable interest rates based on different indexes, raise substantial barriers to its utilization for securitization purposes.

Therefore we believe that there would be substantial structural barriers to the use of a “loan” portfolio for securitization at this time under the existing legal framework. However, BISE’s motivation in the securitization process is more to “recapitalize” its portfolio than it is an interest in transferring the loans off its books. As we mentioned in the Preliminary Report, it may be possible for BISE to consider an issuance of bonds by the Bank, which may be internally and informally collateralized by the loan portfolio. BISE would utilize the “cash-flow” from the portfolio to provide for the payment of the debt service on the bond issue.

This option requires the bank to issue debt and the portfolio would remain an asset of the bank. The informal internal allocation of the cash flow to the bank’s bonds would not be expected to add any value from an investor point of view but to provide the necessary portfolio analysis that is necessary as a precedent to any securitization.

THE BOND ACT

The Preliminary Report identified several issues as to the viability of utilizing an SPV as the issuer of a securitized product. For example, under the Bond Act of 1995 there is a requirement that an issuer have at least a three-year financial history and minimum capitalization levels. The proposed amendments to the Bond Act of 1995 substantially eliminate these obstacles.

INVESTOR DEMAND AND BOND SUPPLY

Interviews conducted subsequent to the Preliminary Report confirmed its findings that there is significant investor demand for a securitization product for municipal debt.

Municipal debt issued in the form of bonds is presently “held” by banks without the option of access to a secondary market. The lack of a secondary market and



investor interest in small issues of lesser known issuers has led the purchasing bank to hold a substantial portion of the bonds they sell. The banks we interviewed indicated a strong interest in a purchasing vehicle for both their existing portfolio and future issues. Purchasing for investment rather than underwriting has limited participation in the market.

Municipal debt issued in the form of bonds is not subject to the transfer restrictions of the Banking Law relating to debt issued in the form of a loan. Therefore the utilization of a bond rather than a loan for the securitized product eliminates the issues raised by the Banking Law as to the transferability, enforceability and confidentiality relating to a loan, as discussed above.

A bank could simply sell its bonds to an SPV. There is also the potential of wrapping the variable rate bond cash flow with an interest rate swap to provide investors with the more desired fixed rate instruments.

REMAINING ISSUES

Although the possibility of the securitization of municipal bonds will be greatly enhanced by the adoption of the proposed amendments to the Bond Act of 1995, several issues identified in the Preliminary Report will remain to be dealt with.

- The applicability of the stamp tax to the transfer of assets could be a financial disincentive.
- The protection of the portfolio from any claims of creditors of the issuer and other parties, i.e., bankruptcy remoteness of the portfolio, (similar to the protection contained in the Mortgage Bond Law)
- The nature and extent of any required disclosure related to either the private or public offering of a securitized product, For example:
 - An independent verification of the sufficiency of the cash flow generated by the portfolio to provide for the scheduled payments of the secured financial instrument on a timely basis
 - The extent of the disclosure relating to the issuers of the bonds that are in the portfolio.

However, these concerns may either be dealt with in the final version of the proposed amendment to the Bond Act of 1995 or may be minimized through the transaction structure.

RECOMMENDATIONS

BISE

The utilization of a bank municipal loan portfolio to provide a securitized asset is subject to substantial structural and legal impediments, which at this time we believe to be prohibitive. However, BISE's motivation to recapitalize its portfolio may be achieved through the issuance of bank bonds. The portfolio's cash flow may be internally allocated to the payment of the bank bonds. In order to accomplish this type of financing there is an opportunity to provide technical assistance to BISE in the analysis of the aggregate projected cash flow to be derived from its portfolio. This cash flow analysis is a necessary precedent to any securitization process.

Such a portfolio analysis would substantially assist the bank in recapitalizing its portfolio and in creating a larger pool of capital for municipal borrowers. Additionally, it would enhance the understanding of the requirements of the securitization process and the need for standardization in the assets that may be securitized.

The level of effort required for this type of assistance is probably two weeks for a Polish consultant with the required quantitative and analytical skills, subject to the direction of an U.S. expert with experience in the structure of cash flows that support securitized products.

Association of Polish Banks

The increased potential of utilizing of a bank municipal bond portfolio as a result of the proposed amendments to the Bond Act present an opportunity to assist the Polish investment community to prepare for this possibility. Such assistance could take the form of workshops relating to the structural elements of a securitized product and the need for uniformity and standardization of the "asset." The development of such a financial instrument has the potential to add additional longer term capital to the municipal demand market as well as to meet the investment needs of investors seeking longer term financial instruments to invest in. Such workshops would deal with the various essential elements of structuring and offering a securitized product, e.g.:

- Portfolio cash flow analysis and independent verification.
- Legal framework and elements.
- Standardization of documentation for the underlying assets of the portfolio, i.e., the bonds.



- Assuring the bankruptcy remoteness of the portfolio.
- Utilization of other financial instruments in connection with the securitization, e.g., wrapping a variable rate portfolio with a fixed interest rate swap agreement so as to meet investor demand for longer term fixed rate debt.
- Appropriate disclosure for the private or public offering of the securitized financial instrument, including relevant disclosure relating to the issuers of the bonds which are in the securitized portfolio.



APPENDIX A

ADDITIONAL SOURCES CONSULTED IN POLAND (Supplement to Appendix I of the Preliminary Report)

1. Bank Ochrony Srodowiska SA; Jan K. Wielgus, Director and Tomasz Puzrewicz, Investment Banking Department.
2. Powszechny Bank Kredytowy SA; Dariusz Kacprzyk, Deputy Director.
3. Weilkopolski Bank Kredytowy SA, Justyn Konieczny, Director.
4. Commercial Union, Piotr Szcepiorkowski, Vice-President.
5. Weil, Gotschal & Manges, J. Mlodzianowska.
6. Bank Handlowy SA, Tomasz Galka, Acting Director.



APPENDIX B

SECURITIZATION OF MUNICIPAL DEBT USAID Project—Poland June 1999

**A Preliminary Report to
USAID Regional Housing and Urban Development Office
Warsaw, Poland**

**Michael A. De Angelis
R. Fenn Putman**

**Contract No. EPE-C-00-95-001100-00
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SECURITIZATION OF MUNICIPAL DEBT

Securitization is the process by which a lending institution's assets are bundled, removed from the balance sheet and are funded by investors who purchase a negotiable financial instrument evidencing the asset-backed indebtedness. Each investor is secured by a share in all the original assets in proportion to his investment.

Our mission as to make an assessment of the viability of the development of a securitized municipal debt instrument in Poland with a view towards establishing a market for longer term capital. A proposed project would be based on the municipal loan portfolio of BISE Bank.

We reviewed various existing papers and research reports relevant to the issue of a securitized municipal debt product in Poland and interviewed the sources listed in Appendix I hereto to determine an implementation strategy. Our approach is to make this assessment utilizing the following analytical format:

- The legal and regulatory environment for securitization
- The compatibility of the BISE portfolio with a securitization product
- The potential structure for the securitization product
- The investor demand for a securitization product

THE LEGAL AND REGULATORY ENVIRONMENT

Although there has been much discussion of the issuance of various securitization products in the commercial sector, our investigation determined that all of the discussed issues in fact had a maturity of less than one year, i.e., commercial paper. Financial instruments of less than one year avoid many of the legal and regulatory issues and therefore these structures do not provide much guidance for the securitization of municipal loans. Polish capital markets have not utilized securitization products to date and there is not any "direct" law applicable. Therefore, the existing legal structure, which is not intended to deal with the issues related to securitization, must be examined and its applicability and interpretations of provisions postulated. Due to the lack of applicable legal provisions and precedent there are a myriad of legal issues to be determined by reference to laws which do not contemplate the proposed activities. Each of the issues raised below would require thorough legal analysis to determine the sufficiency of the existing legal framework and may additionally require either judicial interpretation or clear legislative provisions.

Issuer. The legal structure for securitization revolves around an "issuer" of the participations in the assets.

The issuer may be a "special purpose vehicle" (SPV), created solely for the financing purposes with its activities limited to this function. Such an entity must *be*

“bankruptcy remote” and therefore not engaged in other activities which may have a financial impact on it. The possibility of creating such a corporate body does exist under Polish Law, however, the Polish Trade Law limits the purpose of such an entity to an “economical purpose,” thus raising the issue as to whether the creation of an SPV for the purpose of consummating a securitized financing is an “economic purpose.” The legal conclusion on this issue is not clear and in order to establish the legal validity of an SPV it may be necessary to seek a judicial clarification of this issue.

Currently, under the bond law there is a requirement, inter alia, that an issuer have at least a three-year financial audit history and minimum capitalization levels. This provision does not exist under the proposed revised bond law. Therefore, we must assume the adoption of the proposed provisions.

Additionally, there could be disparate regulatory impacts depending on whether the SPV is determined to be a “corporate,” “banking,” or “municipal” entity, and there is no existing law on the rights of, and duties to investors of, such an SPV.

The issuer may also be an “investment fund” similar to a “closed end mutual fund” in the United States. There has been a growing market for such funds in Poland and presently there are sixteen fund managers of forty-five different funds. A bank may not be an investment fund manager. An investment fund could be created with a portfolio of municipal loans as its sole assets. An investment fund would require a license and SEC approval of the fund’s disclosure. This process would take between 60 and 180 days. The investment fund would be sold as a private placement to less than 300 purchasers.

Portfolio. A securitized structure requires that the portfolio of assets be free of any claims of creditors of the selling bank, and also the SPV. There do not seem to be any laws relating to this issue, however, it is interesting to note that the recent Mortgage Bond Law expressly provides such protection for the portfolio of mortgages held by the mortgage bank in the event of bankruptcy of the mortgage bank. The applicable principle is the same for a securitized financing. It may be reasonable to assume that since it was necessary for the Mortgage Bond Law to deal with this issue that the existing legal framework does not provide sufficient clarity on the issue.

Transfer of Assets. There are several issues that would need to be reviewed and clarified with regard to the transfer of the municipal loans from the bank to the issuer:

1. The applicability of the stamp tax to the transfer of assets could be a significant financial disincentive to the transaction.
2. A review of the loan documentation for each loan is necessary to determine if there are any contractual prohibitions of the transfer of the loan. We have



been advised verbally that such restrictions do not exist in the BISE portfolio. In the absence of a restrictive contractual provision the loan should be able to be transferred without the consent of the borrower subject to the confidentiality issue raised in 3. below.

3. Issues relating to the confidentiality of client information pursuant to the banking laws will need to be resolved in order to share borrower information with the parties to a securitized financing, e.g., rating agencies, issuer, purchasers etc. Much of the borrower information may be in the public domain already; however, it will still be necessary to view the Banking Law provisions related to such confidentiality.

Remedies. Upon the transfer of the assets, it is necessary for the issuer to subrogate to all the rights of the bank in order to enforce the contractual provisions of the loans, raising several issues:

1. To the extent that any of the loans are secured by a mortgage, there appear to be limitations on the ability of any creditor, other than the originating bank, to enforce the mortgage.
2. A borrower may be lawfully permitted to setoff any claims it has against the originating bank by reducing the amount of its loan payments.

Banking Law. It will be necessary to determine the effect of the transfer of assets from the bank on the regulatory and reserve requirements relating to the transferred loans. For example, will the bank continue to be required to “reserve” against the portfolio? The answer may be dependent on the extent of the bank’s continuing responsibility as required for the transferred assets, i.e., whether it is guaranteeing the loan payments to the issuer, or if it has agreed to “buy back” any non-performing” loans. The answers to these questions could have a substantial impact of the financial benefits to the bank to participate in such a transaction and may also determine the structure of the bank’s continuing responsibility, if any, with regard to the transferred loans.

BANK PORTFOLIO

An ideal portfolio would be made up of multiple loans of diversified credits of substantially similar size, with 1) fixed interest rates (See Investor Demand below), 2) good payment histories, and 3) homogenous terms, legal provisions and documentation. Prepayment of the loans by the borrowers would be prohibited.

The BISE portfolio would need to be reviewed and compared to this standard. However, based on our discussions, we do know that:

1. The BISE portfolio of municipal loans is valued at between 20-30 million PLN.
2. Most of the loans are variable rate.
3. There have not been any defaults by borrowers in the portfolio.
4. There are at least three different forms of documentation.
5. Some of the loans do permit prepayment.

STRUCTURE

The structure of the securitization product will depend substantially on the resolution of many of the legal and regulatory issues, e.g., the bankruptcy remote status of the issuer, the enforceability of the loans by a party other than the original lender and the ability of borrowers to setoff against loan repayments claims they may have against the original lender.

The options include the transfer of the assets from the bank to the issuer:

1. and additional security provided by a bank guarantee of any default in payments of the loans;
2. additional security provided by a bank agreement to “buy back” any defaulted loans;
3. additional security provided by the overcollateralization of the portfolio to effect a sufficient reserve for the necessary cash flow. This option may also contain those described in 1. or 2. above; and/or
4. additional security provided by a bank obligation to make payment of any setoff claim made by a borrower against its loan repayments.

BISE has indicated its willingness to consider these options.

It may be possible to consider the issuance of bonds by the bank, which are collateralized by the loan portfolio, which remains segregated, but in the possession of the bank. This option may avoid many of the issues relating to the creation of an SPV but would require the bank to issue debt and the portfolio would remain an asset of the bank.



INVESTOR DEMAND

There is significant investor demand for a securitization product for municipal debt. In particular, the accumulation of assets in the newly formed pension funds will over the course of the next several years create significant demand for financial products for investment. The desired product would have a long-term maturity, 10-15 years, would be at a fixed rate, and not subject to prepayment. It is interesting to note that the additional enhancement of a BISE guarantee did not evoke much enthusiasm and this reaction by the investor community may provide some flexibility in determining a structure that could circumvent banking law and regulatory restrictions.

The existing inverted yield curve environment also presents an opportunity for municipalities to access long-term capital at an interest rate that is less than that which is available on short-term capital.

CONCLUSION

First, it will be necessary to obtain a response from BISE after they have reviewed the issues involved and the type of information with regard to each borrower and loan that must be made available.

The issues raised are complex and the investigatory efforts to analyze and resolve them would be substantial and may include the need for clarification by the judiciary and/or regulatory agencies. There is not any law, which directly addresses the issues raised by securitization, and the result may be to conclude that there is a need for a comprehensive securitization law and regulatory package.

However, the substantial legal barriers raised by the status of an SPV may be avoided by the utilization of the investment fund vehicle. The precedent of existing funds, the willingness of the SEC to consider the disclosure for such a fund, the relatively short time-frame for approval of the fund, and the existing capacity of fund managers are factors that would recommend the investment fund as the vehicle with which to clarify the legal issues raised and the structure the portfolio.

We recommend the further development of the investment fund model for the securitization of municipal loans by a team that would consist of the authors of this report, Wieslaw Oles, Tony Levitas, a BISE representative, a representative of CERA and a designated investment fund manager.

The team would develop a project-financing schedule, determine and prioritize the course of action, seek legal clarification of legal issues with sufficient comfort for a financing to be effected, and proceed to the creation of an investment fund based on the BISE municipal loan portfolio.



APPENDIX I

SOURCES CONSULTED IN POLAND

1. U.S. AID; Steve Horn, Deputy Director, Regional Housing and Urban Development Office.
2. BISE (Bank for Social and Economic Initiatives); [Joanna Wardzinska, Vice President of Management Board]; Wieslaw Sendek.
3. CERA (Central European Rating Agency); Wojciech Lipka, President.
4. Polish Securities and Exchange Commission; Piotr Kaminski, Director of Corporate Finance Department
5. Association of Polish Banks; Krzysztof Pietraszewicz, President; Norbert Jeziolowicz, Advisor to the president; Marek Kowalski
6. DOM; Tadeusz Gacyk, Vice President and Asset Manager.
7. Wieslaw Oles; Oles & Rodyzynkiewicz.
8. SKARBIEC; Ryszard Jach, Deputy President and Asset Manager; Rafal Lerski, Pawel Michalik, Analysts.
9. Banking Association Legal Center; Teresa Hildebrand-Wrzesien, President; Jerzy Banka