AMERICAN UNIVERSITY OF ARMENIA

LL.M. Program

TITLE

Remittance Securitization: A LEGAL FEASIBILITY STUDY

Whether the RA securities regulatory framework allows for an efficient securitization of remittances

STUDENT'S NAME

ALBERT NERZETYAN

SUPERVISOR'S NAME

Hayk Mamajanyan

Table of Contents

Introduction

BACKGROUND INFORMATION

The economies of developing countries with large labor immigration are heavily impacted by remittances. Remittances account for about three times' official development assistance and over half of foreign direct investment annually received. The true size including unrecorded flows through informal channels is believed to be much larger. Data shows that the role of remittances in economies is growing, and from 2000s remittance to World GDP ratio has doubled from 0.376 to 0.764. The Republic of Armenia, with a diaspora of around 7 million, has been largely affected by remittances and from 2005 remittances accounted for approximately 20% of GDP. With that ratio, Armenia is in proximity with states like Haiti, Honduras, El Salvador among others.

The double digit economic growth of Armenia experienced during the period of 2000-2008 was largely influenced by Diaspora's financial inflows: donations, wire transfers and Foreign Direct Investments (FDI). The Diaspora's financial capital was channeled to the economy more in the form of private transfers rather investments, which indirectly creates high dependence of the local economy on external financing instead of creating consistent growth drivers for further economic development. Furthermore, the long-term reliance on remittances creates a moral hazard of less diminished self-dependence among receivers[1].

The best practices of incorporating remittances into domestic economy point to two approaches. *The first* is government matching programs championed by Mexico, where the funds sent from abroad are matched by governments agencies for local infrastructure improvement. Almost 12 million Mexican-born residents live in the US – 10% of total Mexican population. The "3x1" program provides $3 in federal, state and local funds for each $1 remittance received to fund for water, road or similar infrastructure projects. This research will focus on the second approach – remittance securitization (RS). Securitization, a viable financial engineering tool, allows to turn illiquid assets (future receivables) into securities, freeing up regulatory capital for issuers, and generally allows for higher credit rating. First RSs took place back in 1980s in Latin American

[1] Ilene Grabel, "Remittances: Political Economy and Developmental Implications," *International Journal of Political Economy* 38, no. 4 (2010): 86–106, doi:10.2753/IJP0891-1916380405.

countries. For example, the Bank of Brazil raised 250 million USD from Brazilian migrant workers' transfers from Japan[2]. Brazilian banks have raised more than 4 billion USD from RS and throughout the process the transaction rating of securitizations has been higher than the sovereign rating of Brazil. The Republic of Armenia, where remittances account for a sizable portion of economy have not utilized this tool yet.

The Republic of Armenia adopted the Law of Securities Market back in 2007 and as of today it is amended 16 times[3]. The securities market of Armenia is still in the process of maturation and currently there are only four publicly listed companies. Institutional investors are few and the pension funds are in the early maturation process. The relatively small size of Armenian economy, paternalistic approach to business, economic blockade, Nagorno-Karabakh conflict can be explanatory factors for the phenomenon. Nevertheless, the capital markets of Armenia are reluctant to securitize their portfolio and first securitized bond issuance in Armenia occurred in January, 2016.

In a country where the twenty percent of economy remittance dependent, securitization of those remittances can be a viable financing solution for banks and benefit society at large, where funds can be directed to low-interest rate loans for small and medium enterprises. *In short, if 20 percent of Armenia's economy is used as a collateral approximately 10 billion USD financing should be expected.*

RESEARCH PROBLEM

The effectiveness and usability of RS in transfer dependent countries is apparent. The non-use of this method in RA raises questions which need to be answered. Still, the potential answer to the problem could point to a specific issue or a combination of different factors, given the complexity of securitization, its intertwinement with economy at large, political realm and the legal framework. Additionally, securitization should be understood by its economic rationale – the costs and benefits it provides to the issuer.

---

[2] Suhas Ketkar and Dilip Ratha, "Recent Advances in Future- Flow Securitization," *The Financier* 11 (2005): 1–14, http://www.the-financier.com.

[3] Հայաստանի իրավական տեղեկատվական համակարգ, Հայաստանի Հանրապետության օրենքը Արժեթղթերի շուկայի մասին, *available at* http://www.arlis.am

Given the limited scope of this research and its law-oriented approach, this paper aims at ruling out the legislative reasons for non-utilization of RS in Armenia. *Therefore, this paper examines and answers to the question of "whether the RA securities regulatory framework allows for an efficient RS".* The comparative analysis of different legal frameworks, shows no evidence that the Armenian legal framework places additional burdens or high costs on issuers that would hinder the economic rationale for securitizing, consequently leaving the question open for investigation from economic and policy perspectives.

This thesis consists of three chapters. **Chapter 1** studies international best practices concerning RS. Legislative frameworks of two states (Turkey, Brazil) with successful RS will be the subject of comparative analysis. Lastly, the paper will deduce key indicators in legislation needed for successful securitization. In **Chapter 2** the Armenian legislative framework of securities market will be examined and cross-compared with foreign laws. Interviews with senior officials from the Central Bank of Armenia (CBA) and private bank is used for bridging practice to theory. Ultimately, the **Conclusion** presents policy recommendations based on the main findings of the research. **Bibliography** will list all the sources used in the thesis. Interviews with bankers and practitioners will be presented in **Appendices**.

JUSTIFICATION/SIGNIFICANCE OF THE PROBLEM

The securitization of remittances allows for more efficient use of available recourses. Instead of getting loans from international lenders, the securitization option for Armenian banks can be a less expensive and a viable alternative. For addition finance, the government of Armenia has repeatedly issued bonds, however the sovereign rating has remained low at 'BBB' and recently was downgraded to 'B' by Moody's[4]. RS allows to escape the sovereign ceiling and receive higher ratings, which has been the case in Latin American countries for the last three decades. Furthermore, remittances are believed to be stable collateral and often behave counter-cyclically to recipient economy. In a force majeure event, more transfers to recipient countries are expected. Studies of remittances in developing countries suggest that remittances are predictable and can be

[4] Moody's, "Moody's Downgrades Armenia's Government Bond Rating to B1, Changes the Outlook to Stable from Negativee," n.d., https://www.moodys.com/research/Moodys-downgrades-Armenias-government-bond-rating-to-B1-changes-the--PR_345220.

considered as steady stream of financial flow[5]. The advantages of RS and its appropriateness for Armenia are evident, still no bank has engaged it.

This paper seeks to analyze this problem and will be the first to examine RS in the Republic of Armenia. For a more rigorous research and argument, the analysis of laws will be systemic: from receivables contracts in general to security, insolvency and taxation laws. The final outcomes and deliverables is an analytical paper with recommendations and a presentation. *Successful engagement with stakeholders, interviews with banking community, can spark interest and lead to the implementation first RS in the Armenia*.

[5] Daniel Makina, "Mean Reversion and Predictability of Remittances Evidence from Selected Developing Countries," *International Journal of Social Economics* 41, no. 12 (2014): 1209–19.

Chapter 1

International best practices

Securitization & Remittance Securitization

The first modern securitization took place in the US in 1970, when the Department of Housing and Urban development created the residential mortgage-backed security (RMBS) and sold it the secondary markets. Over the course of the 1980s, a market emerged for consumer asset-backed securities (ABS) in the US and RMBSs in the United Kingdom. During the 1990s the markets of ABS and mortgage backed securities (MBS) grew both in Europe and US. In the early 2000s US only issued securitization stood at $1 trillion. Innovative financial engineering allowed for much greater volume of securitization by incorporating a greater variety of underlying assets: from mortgage receivables to insurance and lottery receivables. The securities market came under scrutiny after the global financial crisis (GFC) of 2008. Though certain parts of securitization market played a role in the collapse of financial markets, it was not endemic to all securitization markets. Several securitization products, including auto loans, credit cards, student loans, have a long track record of solid performance[6]. Hence, securitization, as a concept and a form of financial innovation, is neither inherently good nor bad, but rather dependent on the performance of underlying assets and financial system at large.

Remittance dependent countries saw the opportunity of using securitization for raising external finance, where future receivables would be the underlying assets. Among the first countries to capture the opportunity, was Mexico in 1994. The volume of RS has grown rapidly since then and during the 1994-2000 $2.3 billion was raised by Mexico, Turkey, and El Salvador and additional $10billion from 2000-2004. Furthermore, the Standard & Poor's research report indicates that RS and securitization of other future flow receivables in developing countries are performing well[7] as compared to other asset classes. Economic analysis of remittance

[6] Moody's 2012a

[7] Ketkar and Ratha, "Recent Advances in Future- Flow Securitization."

predictability in 21 developing countries from 2003-2013 shows that "remittances are not random flows but a predictable stream of financial flows that can be factored in economic planning"[8]. Additionally, remittances often behave countercyclical: that is, inflows increase when domestic economy weakens. Furthermore, given the geographical spread of diasporas, an economic crisis in one state and consequent decline in remittance inflows affecting the performance of whole asset pool is unlikely. To date there has been over 180 rated transactions and no failures were recorded[9] even during the Asian Crisis, Brazilian devaluation, Turkish events and GFC.

Remittances include check payments, wire transfers, and credit card payments. RS mostly refers to securitization of diversified payment rights (DPR), that is the rights not the obligations that a bank has in the payment orders that it receives to pay funds to beneficiaries. For example, if a bank in Armenia receives wire transfers from the workers abroad in Russia, the bank has right to receive the funds but not the obligation to pay to the recipients – hence DPR. *Therefore, RC is possible on the fact that a bank's receipt of a remittance is separate from its obligation to pay.*

Typical RS involves the borrowing entity, usually domiciled in emerging market economies, pledging its future remittance receivables to an offshore Special Purpose Vehicle (SPV). The cash flows are typically denominated in US dollars and kept in offshore accounts (usually US), which allows for the mitigation of currency convertibility risk, a key component of

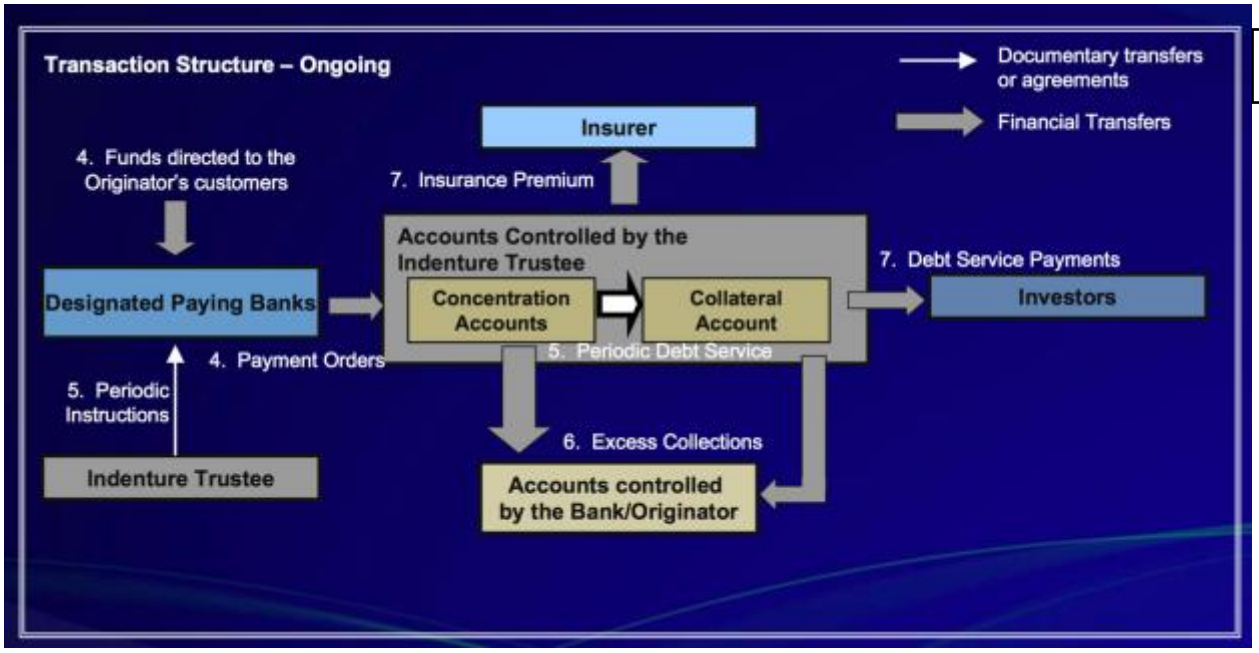


Figure 1

[8] Makina, "Mean Reversion and Predictability of Remittances Evidence from Selected Developing Countries."

[9] Jerome Festa, "Future Flow Securitization Presentation for the MIF Remittance Forum," 2005.

sovereign risk, hence allowing securities to be rather higher than the sovereign credit rating. The SPV in its turn issues debt instruments. Designated correspondent banks are directed to channel remittance flows of the borrowing bank by a trustee (see Figure 1). The collection agent (trustee) makes principal and interest payments to the investors and sends excess collection to the borrowing bank. Typical structural enhancement to RS transaction include but are not limited to: True sale from bank, acknowledgement agreements between paying and originating banks, offshore collection permits, covenants, representations, warranties and triggers, recourse to originator and cash reserve clauses.

The structure of RS functions to isolate originators' jurisdiction from debt instruments, hence minimizing political, economic and currency risks. The isolation, however, is a double-edged sword – and includes the risks concerned with offshore jurisdiction. As mentioned above, a common practice is using US based trusts. While unlikely, risks associated with US jurisdiction, such as taxation, can have a potential impact on transaction. A simple cross comparison between RS transaction rating and sovereign rating, indicates that these transactions often obtain an investment grade rating, two and more points higher than sovereign rating (see Table 1).

Table 1 Remittance-backed future-flow transactions are rated higher than the sovereign

Year	Issuer	$ million	Flow	Transaction rating	Sovereign rating
1998	Banco Cuscatlan	50	Remittances	BBB	BB
2002	Banco du Brasil	250	Remittances	BBB+	BB-
2004	Banco Salvadoreño	25	Diversified payment rights	BBB	BB+

The following section cross-compares the RS related transactions of Brazil and Turkey and their legal frameworks.

Brazil

Case study of Banco de Brasil's (BdB) Nikkei Remittance Trust securitization[10]

** Given the complexity of RS transactions and involvement of numerous parties, this paper cannot analyze every relationship between the parties, also the specifics contractual relationship between*

[10] This example is taken from Ketkar, Suhas, and Dilip Ratha, 2004, *Recent Advances in Future flow Securitization*

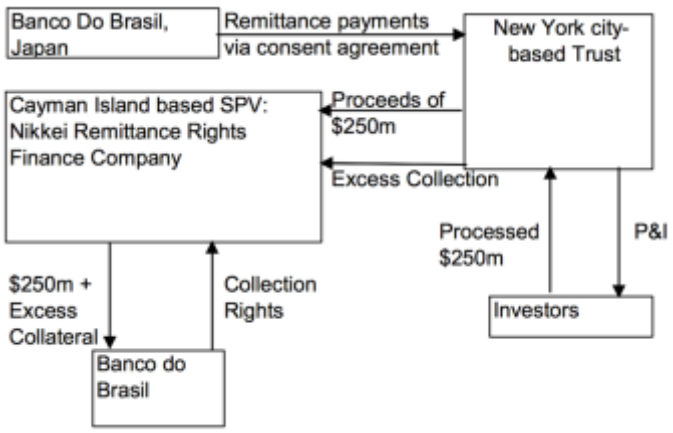
issuers, sellers and other parites is not public and cannot be found. Rather, the paper analyzes the context and structure at large.

Amount: US $250 million. Collateral: US dollar or Japanese yen-denominated worker remittances. Transaction Rating BBB+ v. Republic of Brazil's local currency rating of BB+.

This deal, conducted in 2002, consisted of BdB selling its future receivable rights from Brazilian workers in Japan directly or indirectly to an SPV incorporated in Cayman Island, named Nikkei Remittance Rights Finance company (for structure see figure 2). Afterwards, debt instruments were issued and sold to the investors amounting US $250 million. BdD of Japan was directed to transfer remittances directly to the collection agent managed by the New York based Trust. The Trust collected the receivables to make principal and interest payments to the investors. Excess collections were sent to the originator BdB via the SPV.

The structure of transaction allowed to mitigate the currency convertibility sovereign risk of Brazil by not circulating or transferring remittances to Brazil. Furthermore, the bankruptcy risk of BdB was also mitigated by the creation of SPV, where the only creditors where the investors in the debt instruments. Lastly, the investors (creditors) of SPV were secured, hence they would continue to have access to the pledged security of remittances even of the BdB were to file a bankruptcy.

Figure 2



However, the structure of transaction did not eliminate all anticipated risks. The product risk of Brazilian workers in Japan generating income and their willingness to send it home remained. A common practice mitigation of product performance risk is to issue debt instruments

in amount of not more than 25% of expected remittances[11] - over collaterization or excess coverage. In that case, a pledge of 1 billion remittances over a year raises $250 million in debt instruments. This transaction had debt to coverage ration (DSCR) of 7.64 – where DSCR more than one means the borrower has sufficient income to pay its obligations. Also, the diversion risk remained, that the BdB would sell rights to the receivables to third parties. The above-mentioned approach of pledging more would certainly minimize the risk of diversion to some extent. Another common approach would be a covenant in BdB and SPV agreements, restricting BdB pledging remittances to third parties. Also, there is a risk of corresponding banks for transferring funds directly to an offshore trust, which is resolved by a Notice of Acknowledgement between originator and correspondent bank, that they will make payments to the offshore trust. Lastly, currency devaluation is another risk – not possible to eliminate structurally. Again, excess coverage will minimize the risk but will not eliminate it completely.

Legal framework

General: there is no specific law covering the process of securitization in Brazil. All securitizations are conducted in public offerings. The regulator in charge is the Brazilian Securities Commission (CVM) and the Central Bank oversees and supervises practices. Given the high demand and necessity for the development of Brazilian real estate market, the CVM differentiates between 3 types of issued securitizations: (1) shares of a receivables investment fund, (2) real estate receivable certificates and (3) agri-business receivable certificates. The latter two are sector specific, hence no need for examination. Public offering in Brazil are regulated by CVM Instruction 414[12] (amended by 443 and 446). Securities can be placed by Securitization companies if the aggregate issue amount is less than R$30 million. Otherwise, they require the involvement of security broker as intermediary.

SPVs and Issuance: The investment funds, named as fund for the investment of direct creditors (FIDC) are the most common used type of vehicles, enabling wider variety of securitization structures[13]. They serve the same purpose of SPVs for tax and insolvency remoteness

[11] Venu Prasath, *Credit Enhanced Infrastructure Bonds In Emerging Markets*, 2013.

[12] "CVM Regulation 414" (2004).

[13] "CVM Regulation 356 – The Creation and Operation of FIDC" (2001), http://www.cvm.gov.br/legislacao/inst/inst356.html.

reasons. The tax rules of Brazil do not provide differentiated tax treatment to FIDCs, but a special tax treatment is granted to securitization companies. FIDC can issue different classes of shares and debt instruments. FIDCs require registration at the CVM. A securitization company must be registered with CVM as a public company. By law, FIDC are restricted to borrowing money or leveraging their portfolios. They do not have any other obligations or employees to pay, hence making insolvency less likely. According to the Bankruptcy Act FIDCs are viewed as separate legal entities, hence separate pool of assets.

Receivable transfers: The CVM regulations does not prohibit any type of asset for securitization. If the asset class is seen as risky, the CVM will process a review, instead of automatic registration. The transfer of receivables is not prohibited under Brazilian law and the transfer from originator to the SPV is conducted through an assignment agreement and the consequent execution of it. A notice of sale must be given to the debtors of the receivables. The purpose is to ensure that the debtor will pay future receivables to the SPV and the SPV is the original assignee with the right to receive any payments from the debtor. To strengthen securitization, structure the assignment agreement is usually registered in the Titles and Public Registry operated under the CVM. Furthermore, the Bankruptcy Act prohibits the unwinding of transfers of receivables for the reasons of continuity and securitization. Furthermore, it is believed that over-collaterization is one of most common used mechanism for credit enhancement.

Taxation: There are no transfer taxes applicable to the transfer of receivables. However, if there is a gain, the originator must include this amount for the purposes of corporate taxation[14]. Also, the financial transaction tax (IOF) applies also to securities transaction conducted through financial institutions. The IOF rates are increased or decreased by Brazil's federal government decree, being effective immediately and according to the recent Government decree 8,731 the IOF is set at 1.10%[15]. The IOF mainly applies to foreign transactions and loan transactions (where payment of receivables is guaranteed by the originator) aimed at strengthening Brazilian real. The IOF tax applies to RS, hence adds addition cost layer for the banks.

Analysis: The RS example Banco de Brasil's of 2002 depicts a successful example of RS. The Brazilian regulatory framework of securitization does not pose significant obstacles for

[14] "Brazilian Federal Tax Code" (1966).

[15] "Decree N. 8731" (2016).

securitization. Every asset class, including future receivables, are allowed for securitization, subject to CVM's review. Even if Brazilian banks choose to securitize via an SPV domiciled in Brazil, the regulators allow effective separation of assets for tax and insolvency reasons. Besides, the transfer of receivables is not prohibited and are only subject to notice of sale. The only cost adding burden for securitization is the IOF tax.

Turkey

Case study of İşbank's (hereinafter: Isbank) Diversified Payment Rights securitization program
Amount: $250 million. Collateral: DPRs including wire transfers from abroad workers and SWIFT MT102 & 103 payment orders. Transaction rating A by Fitch v. Turkey's local currency rating of BBB.

Established in 1924, Isbank is today the largest private sector bank in Turkey in terms of total assets, loans, deposits and shareholder's equity. In 2004, Isbank created the DPR program for long-term access to international capital markets. The first DPR securitization was in 2004 with a 10-year maturity. The performance of transaction was solid and even during the GFC of 2008 the performance was rated as "extraordinary" [16]. The success of Isbank's DPR program paved the way for other banks (TuREEFF) to follow. The money raised from DPR program is often diverted to small and medium enterprises (SMEs).

On December 2014 Isbank completed a securitization deal of $250 million in total consisting of two tranches: (1) a tranche of $220 million which has been provided by the Overseas Private Investment Corporation with a maturity of 14 years and (2) a tranche of $30 million by Wells Fargo Bank with a final maturity of 5 years[17]. Isbank sold its future receivables of order payments via SWIFT MT103 to an SPV TiB Diversified Payment Rights Finance Company, incorporated under the laws of Cayman Islands. Afterwards, debt instruments were issued and sold to the investors amounting US $250 million. The SPV collected the receivables to make principal

[16] Felipe Ossa, "Turkish Banks Go It Alone with Diversified Payment Rights," *Asset Securitization Report*, 2014, http://www.asreport.com/issues/2014_5/turkish-banks-go-it-alone-with-diversified-payment-rights-249559-1.html.
[17] "Isbank Annual Report," 2014, http://www.isbank.com.tr/EN/about-isbank/investor-relations/publications-and-results/annual-reports/Documents/İsbank2014.pdf.

and interest payments to the investors. Excess collections were sent to the originator Isbank via the SPV. Structurally, Isbank's RS transaction is analogous to the one of BdB, where an offshore SPV mitigates the sovereign, currency and bankruptcy risks. Furthermore, DSCR was set to above 6 points indicating collection agent's ability to collect.

Legal Framework

General: The Capital Markets Board of Turkey (CMB) is the regulator and supervisor of capital markets, empowered by the Capital Markets Law [18]. It aims to enhance investor protection, the infrastructure of the capital markets, promote transparency and fairness in capital markets along with others. The main securitization governing laws are communiqué on Asset-Backed and Mortgage-Backed Securities[19], communiqué on principles of mortgage finance institutions and communiqué on lease certificates.

SPVs: The CMP sets strict regulations for SPV – named asset financed fund. They are defined as separate asset pooled formed from the process of the assed-based securities sold. Funds are operated under the rules states in the internal bye-laws. Under the CMP regulations funds can only be established in the specific forms and by entities such as banks, financial leasing, finance company and brokerage houses. Furthermore, the regulation restricts asset types to receivables arising from consumer loans and commercial loans, receivables from financial leasing agreements, short term deposits among others. Asset-based securities sold either in public or private offerings must be registered with the CMB. Furthermore, SPVs are insolvency remote because of limited activity restrictions set by the CMB. Still, the CMB requirements for SPVs apply only to onshore securitizations.

Receivable transfers: Under the Turkish Law there is no prohibition on the transfer of receivables other than formal (written agreement). Also, neither the purchase nor the serving of receivables requires a lenience. Notification to the debtors is not required though it is recommended for ensuring that the receivables were not assigned to a third party or were subject

[18] "Turkey Capital Market's Law" (2002), http://www.cmb.gov.tr/regulations/files/CMB_law.pdf .

[19] "Regulation of Asset Backed Securities and Mortgage Backed Securities under New Turkish Capital Markets Legislation," 2013, http://www.allenovery.com/SiteCollectionDocuments/gedikeraksoy/Mortgage_Backed_and_Asset_Backed_Securities.pdf.

to third party claims. The only type of receivables prohibited under the Turkish law is healthcare related receivables. The Execution and Bankruptcy law prohibits the unwinding of transfers of receivables.

Taxation: Under Turkish tax law there are no taxes when assigning receivables[20]. Offshore and onshore SPVs are treated as lending arrangements and 1% interest withholding tax applies. Additionally, Turkey specific stamp tax applies varying from 0.1% to 0.9% levied as a percentage of the value stated in agreements. The above mentioned two takes apply to a typical RS transaction. Other than that, there is no securitization specific taxes[21].

Table 2 Issue	Brazil	Turkey
Regulator	Brazilian Securities Commission	Capital Markets Board
Asset class limitation for securitization	N/A	N/A
Transfer of receivables	Not prohibited, notice of sale required	Not prohibited, notice of sale not required
SPVs	Fund for the investment of direct creditors – typical SPV characteristics	Asset financed fund – typical SPV characteritics, stick regulation
Country specific taxation	Financial Transaction Tax of 1%	Withholding tax of 1% + Stamp tax varying 0.1% - 0.9%.
Over-collaterization	Yes	Yes

Analysis: Similar to the Brazilian legal framework, Turkish legislation allows for a separation of risk between originator and issuers. Additionally, the regulation does not prohibit

[20] "Turkish Taxation System," 2016, http://www.gib.gov.tr/sites/default/files/fileadmin/taxation_system2016.pdf.

[21] Rowe & Maw LLP Mayer, Brown, "Securitisation in Turkey: Some Legal Issues," n.d., https://www.mayerbrown.com/files/Publication/80f802a5-78d5-4d98-a33c-300d32c5498/Presentation/PublicationAttachment/98dbb31e-217d-4ab9-8be4-ddb250396536/NEWSL_GERMANY_JUL07_TURKEY.PDF.

transfer of receivables between parties. Although the restrictions set by CDM are stricter than in Brazil, they are not significant obstacles for future receivable securitization done by large financial institutions. Turkey specific additional cost related to RS transactions are the withholding tax and stamp taxes.

Conclusion: This chapter utilized the method of selecting two countries (given the limited space) with high volume of RS transactions and examine their national legislature and how it enables for an effective securitization. Two jurisdictions allow for a RS and there are no specific provisions or enables that contribute to the transaction. The table below cross-compares two jurisdictions with securitization related issues. Two jurisdictions are identical related to RS, and only country specific taxation stands out. Lastly, the transaction structures of above discussed cases enable the characteristics of typical RSs: separating onshore and offshore risks, mitigation of sovereign and convertibility risks, which result to higher credit ratings than the country's. Additionally, two transactions utilized over-collaterization and DSCR requirements higher than 4.

Chapter 2

Armenian legislation overview

The securitization market of Armenia is underdeveloped. The first securitized bond issuance took place in January 27, 2016. It involved issuance and listing of those bonds in Nasdaq OMX and for secondary market trade. The purpose of the transaction was assisting universal credit companies (UCO) of Armenia (CARD AgroCredit, Garni Invest, Global Credit, Kamurj and Nor Horizon) to issue bonds and attract capital. Given the UCOs legislative restriction on taking deposits, portfolio securitization proved to be a viable alternative for raising external capital. The bonds were issued by a SPV with a final maturity of 3 years - Loan Portfolio Securitization Fund 1, managed by Capital Investments. The transaction raised $2 million from microfinance loans (form of future receivables). Aram Vardanyan, the CEO of pension fund C-QUARDAT, remarked on the vitality of securitizations on Armenia economy "We consider the launch of the asset-backed securities in Armenia as yet another step forward towards fostering the growth of capital markets. The continuity of such issuances is vital for building links between the real economy and the financial sector while providing additional investment opportunities for the long-term investors in the country[22]."

Mr. Vardanyan's point stresses the importance of long-term financing in economic development. Securitizations, be it mortgage or remittance backed, play vital role for long term financing. The annual reports of Turkish Isbank underlies the importance of long-term financing achieved through the securitization of DPRs and mostly the funds raised by RS transactions are directed for the development and assistance of SMEs.

Legal Framework: The Central Bank of Armenia (CBA) is the regulator and supervisor of capital markets is the Republic of Armenia, established under RA Law on the Central Bank of the

[22] "NASDAQ OMX ARMENIA ANNOUNCES THE LISTING OF THE FIRST UCO SECURITIZED BONDS IN ARMENIA," January 7, 2016, https://www.usaid.gov/armenia/press-release/jan-27-2016-first-uco-securitized-bonds-issued-and-listed-in-armenia.

Republic of Armenia of 1996. The RA legal framework related to securitization includes the RA Law on Securitization and Asset Backed Securities, RA Law on Securities Markets, RA Law on Foundations, Regulation N 6/01 of the CBA on Registration of Securitization Funds and Requirements on their activities, Regulation N 4/01 on Prospectus and Reports of the Reporting Issuers and Civil code of Armenia. The following section examines RA laws related to a typical RS transaction.

Definitions: According to the Article 3 of RA Law on Securitization and Asset-backed securities (SABS) *assets* are defined as "cash funds and (or) rights of claim towards them, and (or) other financial assets among the types of assets defined by the RA "Law on Accounting", which ensure or may ensure certain cash inflows"[23]. The definition of includes future receivables – rights of claim towards cash inflows. Asset backed securities are defined as "securities issued by Securitization Funds pursuant to this law which are secured by an asset pool and depend primarily for repayment on the flow of revenues from the assets in the asset pool." This part of definition also does not contradict with the basic concept of RS transactions. Originator is defined as "initial asset owner, who directly or indirectly sells assets to Securitization Fund". Lastly, securitization is defined as "process through which the Originator or the Seller sells assets to the Securitization fund, providing the latter with all the rights relating to the transfer of those assets, while Securitization Fund issues securities backed by the purchased assets and payments on them".

SPVs: The SPVs for securitization are defined in the SABS[24]. Article 4 (1) defines them as "is a non-commercial organization established pursuant to this law, solely for purpose of carrying out securitization and issuance of asset backed securities." Securitization Funds are registered by the CBA in conformity with prescribed procedures. The law requires securitization funds only have possession of the following assets: (1) financial investments by the founders, (2) assets required for the issuance of securities and (3) other recourse prescribed by the law. Furthermore, Article 7 of the Law prohibits Securitization Funds to have any other liabilities other

[23] Հայաստանի իրավական տեղեկատվական համակարգ, Հայաստանի Հանրապետության օրենքը Ակտիվների արժեթղթավորման և ակտիվներով ապահովված արժեթղթերի մասին, *available at* http://www.arlis.am

[24] Հայաստանի իրավական տեղեկատվական համակարգ, Հայաստանի Հանրապետության օրենքը Ակտիվների արժեթղթավորման և ակտիվներով ապահովված արժեթղթերի մասին, *available at* http://www.arlis.am

than those required for asset-based securitization and Article 8 prohibits fund to recruiting employees. The requirements for the registration of Securitization Fund set by Article 18 of the Law are formal and do not necessarily impose an additional burden for the Originator.

Receivable transfers: Article 22 of the SABS stipulates the legal basis for the transfer of assets, including transfer of title. Transfer of assets includes also transfer of payment rights from Originator to Securitization Fund. Originator or Seller is also required to notify the Debtors about sale of assets per Article 22(4). Lastly, the Securitization Fund is required to submit list of assets and documents certifying ownership of those assets to CBA. Article 403 of RA Civil code permits the transfer of creditor's rights without consent in case of secured mortgage bonds and asset backed securities.

Credit Enhancement mechanisms envisioned by Article 31 of SABS include but are not limited to guarantees, excess spread, buy-back obligations, retention, over-collaterization, insurance among others.

Analysis

Consistent view among practitioners in Armenia, including experts at Securities Market Regulation Group of the CBA and the CFO of ACBA – Credit-Agricole Bank, is that the definition of assets as stipulated in the SABS does not and cannot cover securitization of remittances. The reasoning is that the future receivables of banks are not a banks' claim towards them, rather a mere statistical fact[25] and they cannot foresee how banks can securitize on these grounds. Also, the experts at CBA revealed that so for the regulator did not offer a clarification on the term of asset and as they see it now 'asset' does not include remittances. What remains to investigate is whether remittances can be viewed and understood as bank's "cash funds and (or) claims towards them…". Certainly, remittances are not cash funds for the bank – they are cash funds for the receivers. Then, do banks have a claim towards them?

This paper agrees neither agrees nor disagrees with practitioners that the current definition of assets cannot include remittances. At face value remittances are neither cash funds nor banks can have claims towards them. However, the research shows that many successful RSs build on the fact that under the SWIFT terms banks *have right to receive the funds but not the obligation to*

[25] Appendix 1

pay to the recipients. If that is the case, then certainly banks have rights, hence claims to receive the funds. The experts in the CBA did not have any insight about SWIFT terms, and similarly was Division of International Transactions at a private bank. There is no public information on the exact terms and conditions of SWIFT MT102 and MT103 transactions, where banks' obligations and rights would be listed. If we take on the face value the fact that 'right of receiving funds' is cited in secondary literature, also numerous successful RS transactions in the past and present, then it is reasonable to assume the validity of the claim. The agreements between banks and SWIFT organization are party-confidential and hard/impossible to obtain. Given the knowledge gap on SWIFT terms, there are two plausible scenarios: remittances can be understood under the current regulation or a regulatory change is required.

Other than the ambiguity on the definition of 'asset' there are no major foreseeable obstacles. A simple change in legislation or a clarification from the CBA would enable banks to securitize remittances. The next step would be the creation of SPV – Securitization Foundation (Fund) under Armenian legislation. The 'Loan Portfolio Securitization Fund' created in 2016 by UCOs successfully served the purpose for securitizing and isolating risks. Still, there is a common consensus among practitioners[26] that Securitization Fund is not the best form of legal entity suited for the purposes of securitization. SF are subject to the regulations of RA Law on Foundations, which adds additional burden for issuers.

Under the RA Law on Foundations[27], foundations are defined as "a non-commercial organization, which is established based on voluntary contributions of property on behalf of citizens and (or) legal persons, and which does not have members and pursues social, charitable, cultural, educational, scientific, public health, environmental or other public benefit goals." The definition of foundation already poses a problem for securitization and clearly there is a contradiction between the RA Law on Foundations and SABS. SPVs are clearly commercial entities and it is unreasonable to argue that they pursue social, charitable, cultural, educator or other public benefit goals. Additionally, the law requires foundations to maintain board of directors and CEO – an additional cost for the issuer. The law also requires additional reporting and

[26] Appendix 1

[27] Հայաստանի իրավական տեղեկատվական համակարգ, Հայաստանի Հանրապետության օրենքը Հիմնադրամներիմասին, *available at* http://www.arlis.am

publicizing efforts. Under the Article 39 of Law on Foundations, foundations are required to publish in mass media (with a circulation of at least 1000 copies)

> "1) Report about its activities. The report must include information about the programs accomplished; sources of funding; the total amount of financial means used in the fiscal year and in this total the amount of administrative- managerial expenses; the usage of property; the first and last names of the members of the board of trustees, the manager and persons engaged in the foundation's staff, if they have used the foundation's means and services within the accounting year.
>
> 2) Its annual financial report.
>
> 3) The conclusion about the financial report of the person who conducted the audit (auditor), if the value of the foundation's actives exceeds 10 million drams."[28]

Moreover, the law envisions strict supervision mechanisms for foundations activities as they exist and operate for benefiting public. The supervision of compliance with the law is carried out by the RA Ministry of Justice. The foundation has the obligation to notify in writing the RA Ministry of Justice within 15 days after publishing the report envisaged by the abovementioned article.

> "In case if the foundation publishes an incomplete report within the stipulated period, the RA Ministry of Justice shall send to the foundation a written warning suggesting to fix the lacks within one month. If the foundation fails to publish the report within the defined time or does not fulfill the demands of the warning, the RA Ministry of Justice may appeal to the court with a demand on liquidating the foundation." [29]

The abovementioned reporting and supervising mechanisms essentially add additional direct and indirect costs for issuers. While reporting and mass publishing is a financial burden, the supervision mechanisms from state bodies can have indirect effects – diverting potential investors in face of plausible liquidation risk from the government. Paper contemplates that it is no accident that the NASDAX OMX first securitization report mentioned securitization 'Fund' not 'Foundation', which would trigger to some unanswered questions (ex. "Why foundation at first place?") from investors.

---

[28] *RA Law on Foundations, Article 39*

[29] *RA Law on Foundations, Article 38*

Similar questions were asked to CBA experts during the primary research and the answer was convincing. He argued that the Law on Foundation was adopted in 2002 and the Law on Securitization Foundations in 2008. It would be more reasonable for an SPV to be a fund, however there is no general law concerning funds and only in 2010 RA Law on Investment funds was adopted[30]. Mr. Shahnazaryan (CBA) stated that the CBA is planning on adopting a new law for securitization SPVs or making amendments to the current law on funds. He shared same concerns of imposing additional burdens and costs to issuers and the urgency for change.

The analysis revealed two potential legislative problems concerning RS. First being the definition of 'asset' and how the regulator views it. Both our primary and secondary research do not indicate a clear answer. Practitioners are not certain on the idea of Diversified Payment Rights under the SWIFT terms and the confidentiality of SWIFT agreements with bank does not allow for a certain and conclusive answer. Nevertheless, a CBA clarification or a change in the current legislation is not insurmountable. The second hindering factor was the fact of SPVs being foundations under Armenian law. Evidence suggests that regulator is cognizant of the problem and plans to solve it in near future.

Execution of first RS transaction in Armenia

A quick overview of Armenian regulatory framework shows no significant obstacles, other than already planned SPV related regulatory change, for a successful RS. In theory, the RS transactions are not substantially different from other asset backed transactions and the first securitization of Armenia of 2016 can serve as a catalyst for future RS. Transfer of receivables, either ownership of title is, without consent to a Securitization Fund allowed under the Civil Code. The SABS Securitization Fund related provisions enable structural separation between the Issuer and Originator. Also, the law itself envisions typical securitization structure enhancement mechanisms including often used over-collaterization in case of RS transactions. Lastly, Armenian banks are in SWIFT network, hence it is reasonable to assume that same payment rights apply worldwide.

[30] Appendix 1

What remains is the state of capital markets of Armenia and banks' incentives for securitization. It is no accident that no large securitization happened before for numerous reasons, primary being access to international cheap financing. Mr. Zakinyan (CFO of ACBA-Credit Agricole Bank) revealed that international lenders, and the IMF in particular, provides loans to Armenian banks at 5% rate. The process of securitization is burdensome for banks, and they would rather get a loan from either the CBA or international lenders. Same observation was affirmed by CBA experts. Mr. Zakinyan argued that extra financing is not a problem for Armenian banks, but rather there are few places to lend, there is no extra or pressing need for freeing up and raising capital. Another concern is the sheer volume of transactions where remittances to Armenia in 2017 accounted only for $442 million[31], whereas a single Brazilian bank securitized $250 million. Bundling with other asset types could be a solution. Leaving practical shortcomings aside, the consensus is that capital markets of Armenia should and must develop.

The necessity for RS can be seen in a larger context of development of Armenian capital markets. Pensions funds are still in early stages of maturation and can be potential investors. The CBA is willing to take measures for the development. The development is also a national security issue. Overreliance on international lenders and finance is not a course of action of an independent state. The CBA shares this concern also[32], and says that they would rather incentivize banks to raise money locally then depend on external finance. By raising money locally, both the institutions and capital markets will develop and mature.

Conclusion

Based on these findings we can say that RS, as a tool for raising external long-term finance, has a solid track record of performance. Developing countries have successfully executed RS transactions and there are no recorded failures over the last 30 years. The case studies of Turkey and Brazil shows the structural specifics of RS transactions and how a separation of legal entities, be it on- or offshore, empowers risk mitigation. The cross-comparison of two jurisdictions allowed for more comprehensive and inclusive analysis of securities regulation and we can conclude that

[31] "Armenia Remittances," 2017.

[32] Appendix 1

regulatory frameworks related to securitization of Brazil and Turkey were similar, with minor differences in formality requirements and taxation issues.

However, the thesis did attend to a couple of issues: (1) analysis of jurisdiction which has not executed RS transaction, (2) in depth analysis of regulatory formal requirements and (3) Armenian legislation other than securities law and its possible impact on securitization. Furthermore, an economic cost benefit analysis for the execution RS securitization and raising X amount of money v. borrowing the same amount from international lender would make analysis more complete.

To return to our original question, whether Armenian legislative framework allows for an effective RS, our analysis of relevant Armenian laws in comparison with other states' who have executed RS transactions indicates a great plausibly. Based on our findings, there is no indication of legislative reason hindering RS execution, minus minor requirements related to SPVs.

Primary research and communication with practitioners created a general interest toward the concept. This thesis was the first to assess legal feasibly of RS transaction in Armenia and future researches should concentrate on economic and policy aspects of remittance securitization.

Bibliography

Հայաստանի իրավական տեղեկատվական համակարգ, Հայաստանի Հանրապետության օրենքը Ակտիվների արժեթղթավորման և ակտիվներով ապահոված արժեթղթերի մասին, available at http://www.arlis.am

Հայաստանի իրավական տեղեկատվական համակարգ, Հայաստանի Հանրապետության օրենքը Հիմնադրամներիմասին, available at http://www.arlis.am

Հայաստանի իրավական տեղեկատվական համակարգ, Հայաստանի Հանրապետության օրենքը Արժեթղթերի շուկայի մասին, available at http://www.arlis.am

"Armenia Remittances," 2017.

Brazilian Federal Tax Code (1966).

CVM regulation 356 – The Creation and Operation of FIDC (2001). http://www.cvm.gov.br/legislacao/inst/inst356.html.

CVM regulation 414 (2004).

Brazilian Government Decree N. 8731 (2016).

Festa, Jerome. "Future Flow Securitization Presentation for the MIF Remittance Forum," 2005.

Grabel, Ilene. "Remittances: Political Economy and Developmental Implications." *International Journal of Political Economy* 38, no. 4 (2010): 86–106. doi:10.2753/IJP0891-1916380405.

"Isbank Annual Report," 2014. http://www.isbank.com.tr/EN/about-isbank/investor-relations/publications-and-results/annual-reports/Documents/İsbank2014.pdf.

Ketkar, Suhas, and Dilip Ratha. "Recent Advances in Future- Flow Securitization." *The Financier* 11 (2005): 1–14. http://www.the-financier.com.

Makina, Daniel. "Mean Reversion and Predictability of Remittances Evidence from Selected Developing Countries." *International Journal of Social Economics* 41, no. 12 (2014): 1209–19.

Mayer, Brown, Rowe & Maw LLP. "Securitisation in Turkey: Some Legal Issues," n.d. https://www.mayerbrown.com/files/Publication/80f802a5-78d5-4d98-a33c-b300d32c5498/Presentation/PublicationAttachment/98dbb31e-217d-4ab9-8be4-ddb250396536/NEWSL_GERMANY_JUL07_TURKEY.PDF.

Moody's. "Moody's Downgrades Armenia's Government Bond Rating to B1, Changes the Outlook to Stable from Negativee," n.d. https://www.moodys.com/research/Moodys-downgrades-Armenias-government-bond-rating-to-B1-changes-the--PR_345220.

"NASDAQ OMX ARMENIA ANNOUNCES THE LISTING OF THE FIRST UCO SECURITIZED BONDS IN ARMENIA," January 7, 2016. https://www.usaid.gov/armenia/press-release/jan-27-2016-first-uco-securitized-bonds-issued-and-listed-in-armenia.

Ossa, Felipe. "Turkish Banks Go It Alone with Diversified Payment Rights." *Asset Securitization Report,* 2014. http://www.asreport.com/issues/2014_5/turkish-banks-go-it-alone-with-diversified-payment-rights-249559-1.html.

Prasath, Venu. *Credit Enhanced Infrastructure Bonds In Emerging Markets*, 2013.

"Regulation of Asset Backed Securities and Mortgage Backed Securities under New Turkish Capital Markets Legislation," 2013. http://www.allenovery.com/SiteCollectionDocuments/gedikeraksoy/Mortgage_Backed_and_Asset_Backed_Securities.pdf.

Turkey Capital Market's Law (2002). http://www.cmb.gov.tr/regulations/files/CMB_law.pdf .

"Turkish Taxation System," 2016. http://www.gib.gov.tr/sites/default/files/fileadmin/taxation_system2016.pdf.

Appendices

Appendix 1

Interview with Vigen Shahnazaryan – expert, at Securities Market Regulation Group, Central Bank of Armenia

/Disclaimer -Views expressed by interviewee are his own and are not official Central Bank positions. /Non-official transcript and translation/

Question. Mr. Shahnazaryan, now that I have introduced you to the idea of remittance securitization, could you please comment on the idea, and if necessary its connection to the capital markets of Armenia in general?

Response. Well, this is the first time I am hearing about remittance securitization. Our group is tasked with capital markets regulation. I am sure, you are aware that last year the first securitization took place but the volume was not large - approximately 5 million dollars. We had the support of USAID, which guaranteed the 50% of bonds. The securities market in Armenia is underdeveloped, there is a lack of institutional buys and sellers at the same time. Also, there is a question of securities market expertise. No large bank in Armenia has engaged in securitization. If we are talking about the feasibility of remittance securitization, the largest question that remains, what is the asset we are securitizing? Because under Armenian regulations, and RA Law on Securities market defines assets specifically and I think bank's right to receive transfers of its clients cannot be understood within the meaning of "asset" defined by law. Also the Central Bank of Armenia does not have any clarification on asset. So, for the idea to work, I think there is a need for regulation change. If we leave regulation aside, I think the idea is workable and it is the direction Central Bank is willing to take.

Our group is also charged with developing capital markets in Armenia. Banks might not be willing to take initiative and securitize – as it is an additional burden for them. Securitization, as a whole, is a path we want to take – other than raising extra finance, it will strengthen capital markets, lower interest rates. Right now they (banks) are getting cheap money from international banks, be it EBRD, Asian Development Bank or IMF. Hence, there is no motivation for them to

undertake such a complex project. Banks are also getting their financing from CBA under repurchase agreements.

Q. To summarize, what are the major obstacles for successful remittance securitization in RA?

A. I think the biggest obstacle is underdeveloped capital markets and low volume. Even if we were to securitize all future receivables the amount would not be enough for entering US or European markets. Still, the institute of pension funds is now developing and investments in Armenia's capital market is the most desirable policy for the CBA. CBA would rather encourage to invest in domestic capital markets, than banks taking international loans, even if cost-benefit analysis does not add up.

I am fascinated by the idea and will definitely consider it.

Interview with Styopa Zakinyan – Chief Financial Officer, Deputy CEO, Acba – Credit Agricole Bank, Republic of Armenia

/Disclaimer - Views expressed by interviewee are his own and are not official positions. Non-official transcript and translation/

Question. Mr. Zakinyan, now that I have introduced you to the idea of remittance securitization, could you please comment on the idea, and if necessary its connection to the capital markets of Armenia in general? This week I have talked to CBA specialist and I would like to hear an opinion from private sector.

A. This is a fascinating idea and it is the first time I hear about it. What bothers me most is the problem of selling future receivables of our clients. If it is feasible under the SWIFT MT103 terms, then it is doable. Our bank has not engaged in securitization and I think we are not looking forward to it. First we do not have appropriate expertise. Also, the main reason for securitizing is raising finance. Right now, we do not need any additional finance. We borrow both from CBA and international lenders with low interest rate. The IMF, for example, lends at 5% to Armenian banks and our loans start from 10%. There is a lot of money in the market, and places to borrow if needed, but not many good borrowers.