

EXPLANATORY NOTE

to the Draft Law of Ukraine "On Securitization"

1. Justification for the need to adopt the Law

This draft law is aimed at attracting long-term investments in the real sector of the economy by launching the circulation of new securities - securitization structured bonds, the security of investments under which is based on the transparent distribution of cash flows from securitized assets;

The draft law has been prepared in accordance with Regulation (EU) No. 2017/2402 of the European Parliament and of the Council of 12 December 2017 establishing a common framework for securitization and establishing a specific framework for simple, transparent and standardized securitization

The introduction of securitization, which was planned by the Comprehensive Program for the Development of the Financial Sector of Ukraine until 2020 and was scheduled for implementation in 2016, is still relevant.

The provisions of the Law "On Mortgage Bonds" on structured mortgage bonds, which are analogous to MBS (mortgage-backed securities) used in the world, have not been developed into a subordinate regulatory framework and do not meet the updated post-crisis requirements and EU regulations, and should be excluded from this law.

Securitization legislation should be improved to cover other forms of financial assets: loans to businesses, consumer loans to households, agricultural receipts, leasing and factoring agreements, consumer receivables, and other types of assets and monetary claims.

The key point in the application of the draft law is to minimize the investment risk associated with the person attracting financing (the originator). Such minimization is achieved through the separation (segregation) of securitization (underlying) assets, together with the cash flows they generate and other creditor rights. This is an important factor in the context of weak investor protection in Ukraine.

A positive aspect of the draft law is the carefully written regulation of the actions of all participants in the processes of servicing assets and bonds, which, not being related parties, ensure the integrity of a complex mechanism without losing mutual control with the distribution of powers to avoid risk. Particular attention is paid to compliance with the requirements of EU Regulation No. 2017/2402 in terms of the criteria for simple, transparent, and standardized securitization (Simple, Transparent, and Standardized (STS) criteria), which makes the financial mechanism of securitization fundamentally different and more reliable than the pass-through securitization once used in the United States, which led to the global financial crisis of 2008.

The draft law's special rules on securitization of distressed (non-performing) assets, under which bad debts are written off bank balance sheets and transferred to independent management, are long-awaited. This method is recognized as cheaper and more efficient than creating bad asset banks. The introduction of market circulation of distressed assets through their securitization will be facilitated by tax preferences for investors in structured bonds based on such assets in terms of income tax.

Today, central banks around the world, including the Central European Bank and the Federal Reserve, use securitization securities to stimulate economic growth and business activity by introducing policies based on preferences for investors and creditors, including refinancing securitization bonds. Such securities are backed by loans in the real sector and do not lead to an aggravation of inflation and exchange rate risks, as the creation of such assets by lenders precedes bond issues, thus eliminating the impact of the issue on monetary stability.

The priority in settlements with holders of senior tranches of securitized structured notes raises their investment ratings above those of the originators, and sometimes they are even higher than the

sovereign ratings of the country of origin. This makes them a reliable investment instrument for insurance companies, pension and investment funds, and other institutional investors.

The adoption of the draft law will have a significant impact on the supply of instruments for domestic investment by individuals, including through individual investment accounts.

2. Goals and objectives of the Law

The purpose of the draft law is to introduce a financial mechanism for securitization.

3. General characteristics and main provisions of the draft law

The draft law provides for the issuance of new types of structured securities backed by cash flows from a set of segregated assets in accordance with the procedure established by this draft law.

The introduction of securitization requires the creation of legislative conditions, namely

- a) formation of underlying assets that meet the established requirements.
- b) ensuring the integrity of the underlying pool and securing the cash flow it generates in favor of structured bondholders;
- c) limiting the legal capacity of the issuer - a special purpose entity;
- d) separation of powers and responsibilities of unrelated professional securitization participants.

Structured bonds, at least their senior tranches, have undeniable advantages in reducing investment risks compared to debt securities used in Ukraine - corporate bonds, which are usually not collateralized securities, in particular

- a. assets in the securitization pool and settlements with securitization bonds holders will not be affected by third parties, including those who raised funding (originators) and their creditors;
- b. all cash proceeds from assets are distributed to the holders of securitization bonds from special escrow accounts without external interference and obstruction;
- c. the issuer, represented by a special purpose vehicle, is limited in its activities exclusively to the formation and distribution of proceeds from the assets of the securitization pool, and therefore does not assume market and financial risks;
- d. securitization assets cannot be used other than to satisfy the claims of structured bondholders, with the volume of issues limited to the assets of the underlying pools.
- e. a clear division of powers and responsibilities between professional securitization participants, together with a clear and transparent mechanism for the distribution of funds from special escrow accounts, completely eliminate the misuse of funds and abuse;
- f. investors determine the degree of their risk and return by choosing to invest in a particular risk-structured tranche of a structured bond issue, for example, senior tranches have priority for settlement, but subordinated tranches are more profitable. Such risk-based structuring of securitization securities issues is carried out in accordance with the forecast of future cash flows and probable losses made by professional rating agencies (appraisers). The calculation is made in accordance with methods agreed with regulators based on mathematical statistical models that take into account historical data on the asset pool to predict the dynamics of repayments and probable losses, which are incorporated into the lowest tranche of the issue, which will be held by the originator, thereby partially preserving its exposure to risk, which increases its responsibility as a payment servicer for securitized assets.

Financial market regulators may impose additional restrictions and requirements on the underlying assets.

4. State of the legal framework in this area of legal regulation

Legal relations in this area are regulated by:

- The Civil Code of Ukraine;
- The Law of Ukraine "On Joint Stock Companies";
- The Law of Ukraine "On Business Associations";
- The Law of Ukraine "On Capital Markets and Organized Commodity Markets";
- The Law of Ukraine "On Financial Services and State Regulation of Financial Services Markets";
- The Tax Code of Ukraine, etc.

5. Financial and economic justification

The implementation of the draft law does not require additional expenditures from the State Budget of Ukraine.

6. Forecast of socio-economic and other consequences of the adoption of the law

Adoption of the draft law will ensure:

- a. creation and functioning of an effective mechanism for securing investments in the real sector of the economy;
- b. introduction of effective transmission tools for the monetary policy of the National Bank of Ukraine;
- c. creation of market conditions for the introduction of accumulative pension provision for citizens through the launch of low-risk securities;
- d. increasing the volume of the liquid securities market in Ukraine;
- e. Diversification of instruments for attracting credit resources and managing banks' liquidity and capital. Increased lending in the real sector of the Ukrainian economy;
- f. access of enterprises to alternative sources of long-term fundraising in the securities market.