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# Securitisation in South Africa: Historic Deficiencies and Future Outlook<sup>1</sup>

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## ABSTRACT

While American investors have been able to buy mortgage-backed securities since the late 1970s and asset-backed securities since the mid-1980s, investors in South Africa have not become involved in this growing market. Securitisation also spread to Europe, South America, Asia and Australia during the 1980s. The first securitisation in South Africa was completed in 1989, but since then only a few securitised products have been offered to the investment community. The aim of this article is to investigate the reasons for the lack of growth in securitisation in South Africa and to determine whether securitisation will grow to be a significant market in South Africa. The methodology used includes interviews held with investors, securitisation specialists and other structured finance specialists from the banking community. Experience from other countries is noted and included in this article.

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## 1 INTRODUCTION AND PROBLEM STATEMENT

Securitisation has its origins in the United States of America. The development of a secondary mortgage market and mortgage-backed securitisation in the USA in the 1970s can mainly be attributed to two factors, namely (i) the mismatch of funds due to regional imbalances stemming from people moving to the Sunbelt States (Feeney, 1995: 95) and (ii) the interest rate mismatch, which occurred because mortgage loans were made at fixed rates, while lending institutions (thrifts) had to obtain funds at floating rates, causing an erosion of earnings in times of inflation (Cox, 1990: 3).

Illiquid loan portfolios and mounting losses of thrifts lead to federal agency (such as Freddie Mac, Fannie Mae and Ginnie Mae) involvement in mortgage

funding and soon securitisation substituted thrifts as the primary funding vehicle for mortgage lending (Ranieri, 1996: 32-35). The great number of federal agencies in the market contributed to the creation of a liquid secondary market in mortgages in the USA (Feeney, 1995: 95). In 1985 the first asset-backed security, where auto loans served as the underlying collateral for the securities, was issued in the United States (Henderson & Scott, 1988: 82).

Technological advances, such as international telecommunication networks for the distribution of financial information, the elimination of geographical barriers, and globalisation all contributed to the successful global expansion of securitisation (Gardener & Revell, 1988: 17 & Bryan, 1996: 172-173). The United Kingdom was the first market to benefit from US securitisation technology (Thompson, 1995: 32), but unlike the US market, the mortgage-backed security market in the UK developed without government support (Baums, 1994: 8). In the UK, expansion of securitisation has been left to the market which decides where demand is strong enough (Thompson, 1995: 114).

Securitisation has also spread to the rest of Europe and in the 1990s countries such as France, Spain and Italy embraced securitisation through legislative and tax changes (Myerberg, 1996: 148; Shaw, 1991: 8; Thompson, 1995: 34 & DCR, 1999: 27). Legislative restrictions, however, prevented the issue of asset-backed securities in Switzerland and Austria, while a strong banking system and well-developed structures for mortgage finance created a weak demand for securitisation in the Netherlands and Germany (Thompson, 1995: 32-34; Deacon, 2000: 164, 255 and Baums, 1994: 16).

Latin American markets developed differently to European markets due to underdeveloped local bond markets, highly regulated environments and, most importantly, low rated sovereigns. To overcome sovereign risk, securitisations were mainly denominated in US dollars and offered to American investors. The Argentine government encouraged domestic securitisation through new legislative and tax amendments in the late 1990s. More than 100 asset-backed securities have been issued in the Argentine market. Mexico also strengthened its regulatory framework and deepening of its local capital market is perceived to contribute to the development of the local asset-backed securities market (Tibbitts, 2000).

In Australia, issues that support government programmes for provision of finance for low-income mortgage borrowers have dominated the market (Connor, 1991: 144). Securitisation in Australia flourished due to well-documented laws and guidelines with the government facilitating growth, and not directly participating in the securitisation industry (DCR, 1999: 11). In New Zealand a few securitisation issues have taken place. Deregulation of financial

markets has provided an environment conducive to securitisation (Connor, 1991: 157).

In 1999 the issue of mortgage- and asset-backed securities grew to a staggering US\$ 441 billion worldwide. The USA remains the largest market, issuing approximately 75 per cent of the total worldwide, followed by Europe (Woodcock, 2001). In 2000, European issues increased to approximately US\$ 85 billion, with the United Kingdom as the largest European issuer (Fuchs, 2001).

This raises the question of why securitisation has not taken off in South Africa and if it will reach the proportions of asset-backed markets worldwide? This article aims to investigate the reasons for the lack of growth in securitisation in South Africa and to determine whether the market will grow to the same proportions as international securitisation markets. The methodology used includes both a literature survey as well as 18 interviews held with investors, securitisation specialists and other structured finance specialists from the banking community<sup>2</sup>.

The remainder of the article is structured as follows: Section 2 describes the mechanics of a securitisation transaction. Section 3 focuses on South Africa and describes the South African securitisation situation, the factors influencing the lack of growth of securitisation in the local market as well as the future outlook of securitisation in South Africa. The article is concluded in Section 4.

## **2 MECHANICS OF SECURITISATION**

### **2.1 Securitisation defined**

The word “securitization” first appeared in the Wall Street Journal in 1977, although the Journal did not recognise it as a real word (Ranieri, 1996: 31). Until the mid-1980s securitisation referred to debt securities issued by sovereign entities and private corporations as substitutes for bank credit – so-called primary securitisation. Since then, the word has, however, also been used to describe the isolation of cash flows of specific assets from the balance sheet of an institution and the issue of marketable securities, which are supported by the cash flow from assets – known as secondary securitisation (Thompson, 1995: 15 and Feeney, 1995: 1).

Broadly stated, securitisation can be defined as the practice of structuring and selling negotiable investments in order to spread a risk that is normally taken by a single lender or syndicate over a broad group of investors (Donaldson in

Henderson & Scott, 1988: 2). More narrowly defined, securitisation is the process where pools of individual loans, receivables or debt instruments are packaged in the form of securities, credit status or rating of the securities and are enhanced and distributed to investors (Cox, 1990: 2 and Kendall, 1996: 1-2). In short, it involves turning assets into marketable securities (Gardener & Revell, 1988: 17) and thus transferring the rights to an existing asset to investors (Lipe, 1998).

## **2.2 The Securitisation Process**

Lieske and Blumenfeld (1999: 8) illustrate a typical securitisation process in six steps:

### Step 1:

The lender, also called the originator (typically a financial institution) makes a loan to a borrower (the obligor) (Lieske & Blumenfeld, 1999: 8). The originator is the entity that provides the assets subject to the securitisation (Sargent, 1995: 109). Securitisation is not limited to banks and financial institutions. Corporates, public corporations and insurers have also successfully acted as originators in securitisations. Any companies that are characterised by financial stability as well as standardised and centralised servicing of debt are well suited for securitisation (Elmgren, 1995: 11). Fergus & Jacobs (2000: 17) indicate that the success of securitisation depends on the originator's ability to provide new assets of a similar or better quality on an ongoing basis.

### Step 2:

The loan is warehoused until the lender has a sufficient volume of loans to securitise (Lieske & Blumenfeld, 1999: 8).

### Step 3:

The lender sells the loans to a special purpose vehicle (SPV) (Lieske & Blumenfeld, 1999: 8). The special purpose vehicle (SPV) is an independent, specially formed, single-purpose entity that purchases the loans from the originator (Wood, 1995: 46). The SPV is organised for a specific purpose and its activities limited to those necessary to accomplish such purpose in the transaction (Taplin, 2001). The SPV houses the underlying assets and issues the relevant asset-backed instruments to investors. Depending on accounting and legal regulations, the SPV can take the form of a company or a trust (Oliver & Sallis, 2000: 23). The SPV must be insulated to ensure that events that happen to the originator, such as bankruptcy, do not affect it. This is referred to as making the SPV 'bankruptcy remote'. Secondly, it must be ensured that the transfer of funds from the originator to the SPV cannot be interfered with. This is achieved through a 'true sale' of receivables (Schwarcz, 1991: 23).

Step 4:

The SPV pays for the loans by simultaneously selling certificates, representing ownership of the loans, to investors. A credit rating agency rates the securities issued by the SPV (Lieske & Blumenfeld, 1999: 8) and this reflects the quality of the securitisation issue (Fergus & Jacobs, 2000: 18). The rating provides a view of the credit risk of the security to investors and the role of rating agencies in the securitisation process cannot be over-emphasised (DCR, 1999: 5 & Baum, 1996: 48). The rating agency also continues to assess the performance of the assets in the portfolio and credit enhancement levels throughout the life of the transaction. In this way peace of mind is provided for trustees.

Step 5:

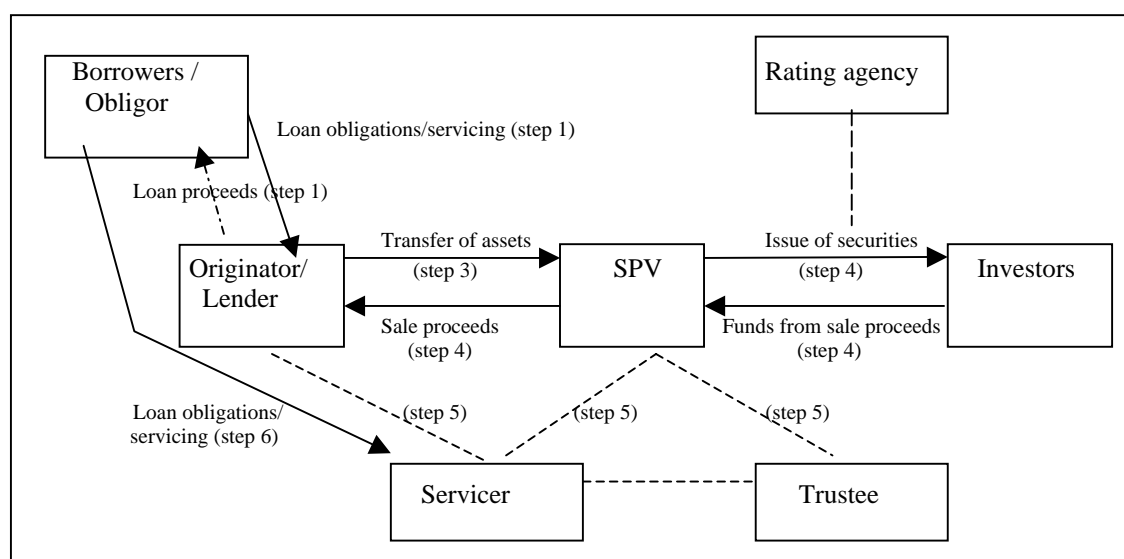
A servicer is appointed and provides administration for the duration of the issue (Lieske & Blumenfeld, 1999: 8). Its duties entail normal cash collection on the underlying assets, management of arrears and client relationship management. The originator usually performs this function, but there must also be a 'back-up servicer' (unrelated to the originator) in place who would be able to take over this function if the originator is unable to continue this task due to, for example bankruptcy (DCR, 1999: 5). The servicer charges a market-related fee for administrative services (Oliver & Sallis, 2000: 24).

A trustee can also be appointed to ensure that investors are paid in accordance with the terms of the securities and to monitor the performance of the servicer (Lieske & Blumenfeld, 1999: 8). The trust is established for the benefit of the investors in the paper issued by the SPV and the trustee is responsible for protecting the rights of investors. It controls and monitors the SPV and has the ability to close down the vehicle in circumstances it deems appropriate. If the trustee appointed is a highly reputable bank or auditor, this introduces integrity into the securitisation process (Oliver & Sallis, 2000: 24).

Step 6:

The borrower is instructed to make payments to the servicer and direct all enquiries to the servicer (adapted from Lieske & Blumenfeld, 1998: 8, DCR, 1999: 5-6, Koornhof, 1996: 10 and Thompson, 1995: 8)

Additional parties that may be involved in the process include legal counsel, to assist in the legal documentation and interpretation of the applicable laws, and an external credit enhancer (discussed below) (Baums, 1994: 4).

**Figure 1** Securitisation process

Adapted from: Lieske & Blumenfeld, 1999: 8 and DCR, 1999: 6

The quality of the assets and the rating that the originator wants to achieve determine the level of credit enhancement in a securitisation transaction (Lin, 2000a: 10). Through credit enhancement, a better rating can be achieved. Credit enhancement may be provided internally, by the originator, or externally, by an independent third party (Oliver & Sallis, 2000: 24). The transaction normally uses a combination of internal and external credit enhancement techniques. Internally provided credit enhancement techniques include:

- Cash collateral or a cash reserve account where a cash deposit (also referred to as a reserve fund) is kept in the structure of the securitisation transaction to absorb losses due to cash flow delays or defaults (DCR, 1999: 6).
- Excess spread, which is the difference between the interest generated on the securitised assets over the cost of the funds, namely the yield on the notes issued. It represents the value of interest income minus interest expenses (Lin, 2000b: 11-12).
- Securities subordinate to A-class securities in principal and interest payment may also be issued (DCR, 1999: 6). Each successive class has a lower rating than the one preceding it, indicating higher credit risk (Lin, 2000b: 11). A higher rate of interest is applicable to subordinate securities, to compensate for the additional credit risk (DCR, 1999: 6).
- Overcollateralisation means that the face value of the pool of assets exceeds the securities issued from the pool. Any early amortisation of some of the assets creates additional cash flows, which are kept within the SPV to serve as a buffer against possible losses (Elmgren, 1995: 16-17).
- Recourse to the originator is a situation where the originator guarantees the covering of a specific maximum amount of losses on the pool (Chammah,

1991: 4). This improves creditworthiness by gaining access to the originator's resources and by creating an incentive for the originator to service the portfolio diligently (Elmgren, 1995: 17).

- Securitisation triggers are events that are defined to protect senior securities holders. Such an event may include, for example, that if the value of the collateral falls below a certain specified level, all payments to junior note holders will be stopped to ensure that enough cash is available to honour payments to senior note holders (Behr, 2001).
- Early amortisation events trigger the immediate repayment of investors on their occurrence (DCR, 1999: 7). For example, if the level of assets falls below a certain level, the securitisation should wind up and investors should be paid off immediately (Behr, 2001).

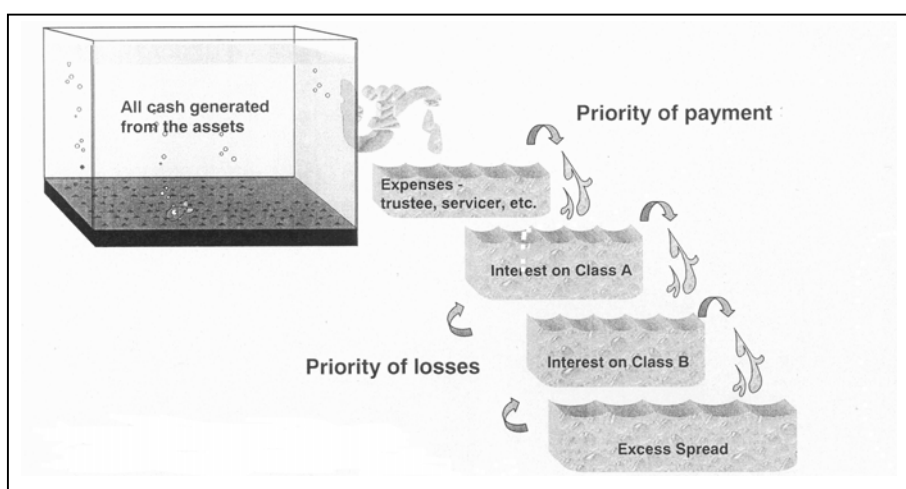
The following external credit enhancement techniques are available:

- Pool insurance may be taken out on the assets that produce the cash flow in the securitisation transaction (Jennett, 2001).
- The liquidity facility is designed to provide the SPV with the necessary liquidity to meet short-term cash requirements (Deacon, 2000: 351). The facility is provided by another institution and is used to make timely payments to senior note holders in the event of short-term liquidity shortfalls. It is set at a fixed amount or percentage, for example the value of the next payment to senior note holders or 5 per cent of the assets in the pool (Behr, 2001).
- The liquidity facility may also take the form of a credit line when short-term commercial paper is issued at regular intervals by the SPV. The liquidity line is a promise by a highly rated financial institution to purchase the new commercial paper issue in the event of a market-wide disruption where the issuance would otherwise be impossible (Lin, 2000b: 12).
- A credit wrap is a financial guarantee that is provided by a third party. The third party guarantees to step in and meet the obligations of the SPV to investors if the SPV is unable to do so (Jennett, 2001).
- A third party, such as a highly rated bank, may provide a letter of credit that promises to cover losses of the SPV up to a maximum amount (Elmgren, 1995: 17).
- Interest rate swaps are used to satisfy investors' demands for fixed and variable rate securities. The SPV normally receives a fixed interest rate on the underlying assets, but investors that require a floating interest rate note may require the issuer to engage in an interest swap agreement with a swap counterparty, where the fixed rate is swapped with a floating rate payment (Sargent, 1995: 109).

### 2.3 Waterfall of payment

One of the fundamental mechanics of a securitisation transaction is the 'waterfall' (Lin, 2000a: 10). The cash flows in a securitisation transaction follow a waterfall to create different risk buckets or tranches (Taplin, 2001). The waterfall symbolises the order of cash distribution to the various parties involved in a securitisation transaction and indicates the priority of each stakeholder receiving funds (Lin, 2000a: 10). This waterfall is illustrated in Figure 2.

**Figure 2 Waterfall of payment**



Source: Taplin, 2001

As indicated by Figure 2, trust expenses and administration fees are paid first from the cash generated by the underlying assets. Secondly, standby fees for liquidity lines or letters of credit are paid (if applicable). Thirdly, senior note holder and swap expenses are paid. Fourth in line for repayment are junior note holders and if there is any cash flow left, it is used to top up the cash reserves (excess spread) in the SPV (Lin, 2000a: 10). The excess spread thus provides the first line of defence for losses, followed by junior note holders (Taplin, 2001). Excess spread and reserves and junior note holders serve as credit support for senior note holders (Lin, 2000a: 10).

## 3 THE SOUTH AFRICAN SITUATION<sup>3</sup>

### 3.1 Securitisation in South Africa

United Building Society Ltd. (now part of ABSA) conducted South Africa's first securitisation in November 1989. It involved the securitisation of a R250



million pool of mortgages (Faure, 1991: 25-27). Shortly afterwards, in 1991, the second securitisation was conducted by Sasfin (Pty) Ltd. Instalment rental loans formed the underlying asset for the asset-backed securities issued by the special purpose vehicle (Van den Berg, 1998: 72-3). Sasfin still uses the SPV and issues new asset-backed securities regularly. Besides the Sasfin issues (which are placed privately) there was no activity in the securitisation market in South Africa between 1991 and 1999.

The beginning of 1999 saw a renewed interest in the securitisation market in South Africa, which led to a number of transactions being completed since 1999. The best known transactions include the following; the first in a series of securitisation transactions was completed by the Retail Apparel Group (RAG), who securitised R600 million worth of its debtors book (Wood, 2000: 64) and in October 1999 Unibank securitised R430 million of its term loan book (Mettle, 1999).

The latter transactions were followed by the Kiwane fund in May 2000. Gensec, JP Morgan and Real Africa Durolink launched the Kiwane fund, which is a collateralised debt obligation fund where corporate bonds and debt serve as the underlying assets for security issues. The fund started with an issue of R500 million and will cease the first issue when it reaches R2 billion.

In June 2000 Rand Merchant Bank (RMB) completed South Africa's first international securitisation transaction. US\$ 250 million worth of international Visa, MasterCard and Cirrus voucher receivables, generated by the usage of credit and debit cards by non-South African residents in South African organisations that use FirstRand Bank to service their card receipts, were securitised and offered to European investors. A second international securitisation transaction by RMB followed shortly and took the form of a collateralised debt obligation (CDO). US\$ 540 million's worth of high-yielding corporate bonds served as underlying collateral for the transaction (Raine, 2000: 27).

In November 2001 SA Home Loans, with the assistance of Standard Bank and JP Morgan, issued MBS to the value of R1.25 billion. These notes were listed on the Bond Exchange of South Africa and both senior and junior notes were offered to the investor community.

This increase in securitisation continued in 2002 and eight new issues were listed on the Bond Exchange (see BESA, 2003). Procul Limited was the first to issue R1.282 billion worth of Class A notes and R710 million Class B to Class G notes in June 2002. The motor instalment receivables book of Wesbank backs these notes.

The second issue (in July), Fresco 1, comprised R188 million worth of Class A fixed rate notes, R183 million Class B fixed rate notes and R711 million Class C to F notes. The underlying collateral for the transaction was R1.082 billion worth of R194 bonds. Also in July OntheCards Investments issued R1.73 billion worth of Class A floating rate notes and R200 million Class B floating rate notes. The originator was Edgars Consolidated Stores Limited (Edcon), whose instalment receivables book comprised the underlying assets of the transaction.

At the end of July 2002 the Infrastructure Finance Corporation Limited (INCA) registered a collateralised debt obligation (CDO) programme worth a maximum of R10 billion. INCA is the primary private sector infrastructure funder of local authorities in South Africa and municipal loans are the underlying asset of the transaction.

In November 2002 Fintech Receivables issued R619 million worth of Class A notes and R34 million Class B notes backed by office equipment lease contracts originated by Fintech (Proprietary) Limited, Technologies Acceptances (Pty) Ltd, Fintech Information Services (Pty) Ltd and Corporate Finance Solutions (Pty) Ltd. Also in November the SA Home Loans (through the Thekwini Fund 2) issued another R1 billion worth of Class A notes, R55,194 million Class B notes and R27.056 million worth of Class C notes.

In December 2002 ABSA Corporate and Merchant Bank registered the Asset Backed Arbitrated Securities (Pty) Ltd., which is a domestic asset backed note programme. The maximum value of this programme is R15 billion and different assets will underlie the issue, with these asset classes separated into different series. In December 2002 Private Mortgages 1 (Pty) Ltd issued R923 million worth of Class A notes and R77 million Class B notes. This is the fourth MBS transaction in South Africa and amortising home loans of Investec form the underlying collateral for the transaction.

### **3.2 Reasons for the slow growth in securitisation**

From the international expansion of securitisation described in the introduction it is evident that securitisation will flourish in two instances: (i) when regulations favour securitisation or (ii) when there exists a strong demand for and supply of asset- and mortgage-backed securities. None of these factors were present in South Africa during the 1980s and 1990s.

The regulatory framework affects all components of the securitisation transaction, these being, the transfer of assets, the issue of securities, the

establishment of the SPV, the taxes on the originator, SPV and investors and the accounting treatment of the originator and the SPV.

With regard to the regulatory environment for securitisation in South Africa, the following uncertainties and problems have hampered the development of the market:

- The regulations set by the South African Reserve Bank (SARB) for regulating securitisation (as in the Securitisation Notice of 1992 – see RSA, 1992a), created uncertainty amongst originators and especially amongst banking originators. Phrases included such as “if a bank securitises ...” created two different views, namely (i) that only banks may securitise assets and (ii) that non-bank securitisations do not have to comply with the regulations.
- The regulations set in 1992 did not allow the originator to invest in the transaction, for example by taking up subordinate securities. In the event of the originator investing in the transaction, the assets cannot be taken off the balance sheet of the originator for prudential requirement purposes thus implying full capital and liquidity holding by the banking originator.
- The 1992 regulations did not allow for any capital arbitrage opportunity since mortgages carry a 50 per cent risk weight in determining the capital holding of banks, while investment in mortgage-backed securities carries a 100 per cent risk weight (implying more capital holding for investment in mortgage-backed securities).
- The initial Commercial Paper Notice (RSA, 1992b) was created in fear of a second Masterbond scandal but was adapted in 1994 (RSA, 1994). However, it still created confusion and kept issues from being listed on the Bond Exchange, since some players interpreted private placing of asset-backed securities as not offering them to the public, thus rendering compliance with the Notice unnecessary.
- The Accounting Standards that apply to securitisation include AC 125, AC 133 and AC 412. While the true sale criteria in AC 125 (see South African Institute for Chartered Accountants, 1998) can be met by securitisation, there is almost no possibility of the SPV not being consolidated with the originator according to AC 412 (see South African Institute for Chartered Accountants, 1999). This consolidation undermines the bankruptcy remoteness of the SPV and brings the safety of the structure for investors into question. It serves as a serious impediment to the development of the market.
- Stamp duties payable on mortgages (in terms of the Stamp Duties Act – see RSA, 1968) make it expensive to securitise mortgages, while the stamp duties on securities issued for the first time also increase the cost of listing securitisation transactions on the Bond Exchange.

- The Value Added Tax Act (see RSA, 1991) does not favour securitisation since all fees received by the servicer are subject to VAT, thus increasing the cost of the transaction.
- Since tax in South Africa is payable on income that is accrued or received, whichever arrives first (see RSA, 1962), the securitisation of receivables calls for more complex and less flexible structures to reduce the tax cost of the transaction.

The second reason that securitisation has not shown the exceptional growth it has in other countries, may be attributed to both a lack of supply as well as demand. Securitisation has to come from a need, and the need was not yet there for many of the investors and originators.

The demand-side reasons include the following:

- Due to the limited number of issues and the relatively small size of the securitisation transactions prior to 2001, there was a lack of liquidity in asset- and mortgage-backed securities, which was a source of concern for most investors.
- Closely related to the liquidity concern is the concern about the tradeability of these securities, since there was no secondary market in these products. The lack of market makers in asset- and mortgage-backed securities contributed largely to this problem.
- Besides the concern for liquidity in small transactions, the relatively small size of the transactions created another problem for investors. Investors do not want to take up the whole issue or too large a percentage of the total issue, but the investment should still be large enough to justify the effort taken to scrutinise the transaction.
- Limited trust in rating agencies and credit ratings assigned to securities together with the reliance on in-house assessment of the credit quality of the securities contributed to the slow growth in demand.
- The originator of the assets is still important to the investor who does not rely solely on the credit rating, since this is an indicator of the credit quality of the underlying assets as well as the operational risk within the transaction where the originator remains the servicer.
- Investors also face portfolio restrictions, which restrict their investment to certain classes of assets in terms of both credit quality and liquidity.
- Securitisation is a relatively new concept in South Africa and investors are concerned as to whether they understand all the risks involved in asset- and mortgage-backed securities, since there is almost no track record of their performance in the South African market.
- Government guarantees on mortgage-backed securities (as is the case in the United States) could have immediately made these securities an attractive

investment option, but the lack of guarantees led to caution and sluggish development of the market.

- Historically high inflation rates in South Africa caused investors to invest in property rather than debt.
- Historically high interest rates are not conducive to the development of a debt market, but have led to the development of a strong equity market, causing the investment community in South Africa to be an equity investment community. The volatility in interest rates since 1991 caused corporate treasurers to be hesitant in investing in debt.
- Closely related to the previous constraint are the lack of a corporate bond market and the lack of depth in the secondary bond market, since corporate bonds are often viewed as the predecessor of more complex debt issues, such as asset- and mortgage-backed securities.

The supply-side reasons include the following:

- The main obstacle to growth in securitisation identified by originators is the time and cost associated with securitisation. The process takes more than a year for first time securitisations and the cost involved makes it too expensive to securitise small amounts of assets. Some major costs in South Africa include the cost associated with the legal session of mortgages, the need for new technology and the cost of credit enhancement.
- The high price required by investors has made it difficult to securitise profitably. The investor's premium is increased by the novelty of the concept and the lack of liquidity, while complex structures (to deal with VAT) increase the premium even more.
- The lack of default and delinquency data as well as systems to access the appropriate data, add to the difficulty of rating and structuring the transaction.
- Banks in South Africa are still asset-driven and having a critical mass in terms of assets is seen as a means of survival. Therefore large banks have not embraced securitisation.
- Banks in South Africa have adequate capital, and securitisation offers no capital arbitrage opportunity.
- Large banks in South Africa do not face any liquidity constraints and there is currently no rationale for these banks to securitise.
- Prior to 1994, capital could not be taken out of the country, making capital cheap relative to debt and causing corporates and banks to issue equity rather than debt.
- The large corporates in South Africa had easy access to funds via banks and there was thus no need to securitise for funding purposes.

In addition to the above-mentioned demand and supply reasons, there still is a perception in the market that businesses only securitise when they are in trouble.

Organisations that entered the market when they were already experiencing financial difficulties, contributed to giving securitisation a bad reputation in the local market.

### **3.3 The future of securitisation in South Africa**

The question that remains is whether securitisation will grow to be a market of significant proportions in South Africa? Certain changes in the demand, supply and local conditions are pointing towards securitisation growth. These changes include the following:

- Government is decreasing its bond issues due to smaller fiscal deficits and privatisation. This causes investors to search for other types of debt to invest in.
- Investors have shown increased interest in asset-backed and mortgage-backed securities and have set up their own credit assessment departments. The appetite for these instruments is thus increasing.
- The corporate bond market has started to grow with the large banks issuing corporate bonds and international players acting as market makers in these bonds. Corporates have also started to access the debt market in order not to have the constraints and covenants associated with bank lending. More corporate debt issues will lead to an increase in the depth of the secondary market in debt instruments.
- Capital is becoming a scarce resource since there are more national and international investment opportunities available. This causes banks to price capital more correctly and may lead to securitisation by large banks in order to improve their capital efficiency.
- Banks are no longer rated on size by the JSE, but rather by return on equity (ROE). ROE is therefore becoming more important to banks as well as ratios such as return on assets. This causes a decreased focus on assets and an increased focus on profitability, which may lead to securitisation by larger banks.
- Rating agencies and ratings are becoming more widely accepted in the industry and investors rely on ratings as a starting point in their assessment.
- The South African Reserve Bank has shown support for securitisation. The new regulations issued in December 2001 by the Bank have brought about more certainty, opened the door for corporates and will hopefully spark securitisation initiatives.
- International banks have entered the market. Their role is twofold. Firstly, the banks have brought more sophistication to the market as well as expertise in marketing the benefits of securitisation. Secondly, the international players increased competition in the market. South African

banks cannot afford to make losses in the competitive environment and this may lead to securitisation in order to improve profitability.

- Kiwane has assisted in increasing the knowledge level and understanding of what securitisation entails.
- The prices of asset- and mortgage-backed securities are becoming more realistic. The insistence on ratings and the efforts by the Bond Exchange of South Africa (BESA) to develop the bond market has led to more consistent pricing.
- The decrease in interest rates during 2000 and the beginning of 2001 made it more sensible for corporates to access the debt market.
- More players have entered the market and the increased competition and expertise have decreased the cost of securitisation. The transactions and structures are well thought through, simple and robust.
- Perceptions about securitisation are changing. The involvement of large international banks as well as the FirstRand securitisation transactions has assisted in changing the perception that an organisation will only securitise when it is in trouble.

#### **4 CONCLUSION AND FUTURE EXPANSION**

The aim of this article was to determine the reasons for the lack of growth in securitisation in South Africa during the 1980s and 1990s and to determine whether the market will grow to the same proportions as asset- and mortgage-backed markets elsewhere in the world.

Based on the international growth of securitisation, two catalysts for securitisation growth were identified, namely (i) when regulations favour securitisation and (ii) when the demand and supply conditions in the country favour securitisation. In South Africa, the authorities have not facilitated growth through legislative changes and tax amendments, as was the case in countries such as France, Spain, Italy, Argentina, Mexico and New Zealand. Nor has the government become involved in the securitisation market through explicit guarantees, such as in the USA, or support, such as in Australia. The initial regulations set by the South African Reserve Bank served as a deterrent, rather than a stimulus to the development of the market. The regulations created uncertainty and were unnecessarily strict in reaction to the Masterbond scandal. The current tax laws in South Africa increase the cost and complexity of securitisation transactions, while the strict application of Accounting Standards undermines the safety of the securitisation structure.

The approach followed by the South African authorities was similar to that of the British authorities and the growth of the market was left to demand and

supply factors of which both have been weak. The lack of a liquid secondary market and government guarantees, limited trust in rating agencies, portfolio restrictions, historic high inflation and interest rates and the underdeveloped corporate bond market are all factors that limit the demand for asset- and mortgage-backed securities. The time and cost associated with securitisation transactions, high investor premiums, lack of default and delinquency data, asset-driven culture of South African banks with adequate access to capital and liquidity (especially for the larger banks) and corporates' easy access to bank funds limited the supply of asset- and mortgage-backed securities.

Recent changes in conditions suggest, however, that the environment is changing and that securitisation may indeed grow in South Africa. The main predictors of change include the decrease in government bond issues, increased investor knowledge appetite for asset- and mortgage-backed securities, growth in the corporate bond market, banks being rated on profitability rather than asset size, wider acceptance of rating agencies, changes in Reserve Bank regulations, more players entering the market and prices of securities becoming more realistic and changing perceptions regarding securitisation.

To further develop the asset- and mortgage-backed market in South Africa, the following factors would assist in developing the market to international standards:

- An improvement in rating methodologies making them more comprehensive and ensuring that they meet international standards, together with a greater presence in South Africa of international rating agencies. Confidence in the securitisation structure and the quality of the assets are important to investors and a rating by an international trustworthy agency therefore makes a difference to investor perceptions of the quality of the market. There is currently only one international office of an international rating agency in South Africa (as well as one affiliation) and the presence of all the international rating agencies would boost confidence in the market and therefore also demand.
- A greater degree of large bank involvement in the market to improve both the size of the issues and the profile of the market. Large banks are originators that have both the quality loans and the required portfolio size to securitise effectively. As major players in the South African financial market their entrance into the market would signal trust in asset-backed securitisation.
- Changes in the capital requirement of mortgage-backed securities for banks to allow capital arbitrage and to encourage banks to securitise. This would certainly signal confidence in mortgage-backed securities from the Reserve Bank and would create an incentive for the large banks to not only invest in the market, but also participate as originators in the market.



- Government guarantees on mortgage-backed securities (similar to the Ginnie Mae, Fannie Mae and Freddie Mac structures in the United States). Although it is doubtful if government in South Africa will give guarantees, it would certainly assist in generating sufficient trust and volume in the market.
- A decrease in stamp duties together with amendments to the VAT Act to favour securitisation. Legislative changes in countries such as France and Spain aided significantly in developing the market. However, serious consideration should be given to whether small changes to these tax acts would decrease government income so severely that they cannot be justified.
- A rethink about the applicability of the accounting standards (especially AC 412 and AC 125) for the South African market. Again the question needs to be asked whether the implementation of these accounting standards contributes significantly to the safety of banks and other institutions, since their application is constraining the development of an efficiently functioning securitisation market.

These recommendations mainly address the areas where there is still uncertainty in the market and further research on the common indicators of a well-functioning asset-backed securities market could provide even more insight.

## ENDNOTES

- 1 The authors would like to thank the Research Unit: Business Mathematics and Informatics at the PU for CHE for the financial support received for this research.
- 2 The list of interviews is included in the References.
- 3 Unless stated differently, the information included in this section is based on the results of the interviews listed in the References.

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