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Practitioner Update

Issue 5
The application of merger provisions of the Competition Act 89 of 1998, as amended, to asset securitisation schemes

1. Preface

1.1. In terms of section 79 of the Competition Act No. 89 of 1998, as amended ("the Competition Act") the Competition Commission ("the Commission") may prepare and disseminate Updates to inform and clarify the Commission's policies and adopted approaches to specific issues on any matter within its jurisdiction. These Updates are not binding on the Commission, the Competition Tribunal or the Competition Appeal Court in the exercise of their respective discretions, or their interpretations of the Competition Act.

1.2. While this Update is not binding on the Commission, it sets out the approach the Commission is likely to adopt to certain transactions outlined below and may be updated from time to time to account for future developments.

2. Definitions

In this Update, unless the context indicates otherwise, the following definitions shall apply:

2.1. "bank" means a public company registered as a bank in terms of the Banks Act 94 of 1990, as amended, including its subsidiaries;

2.2. "commercial paper notice" means the regulations contained in Government Notice No.2172, published in Government Gazette No.16167 on 14 December 1994 issued in terms of the Banks Act No. 94 of 1990, as amended ("the Banks Act") and includes any amendment to the said regulations;

2.3 "securitisation scheme" means a synthetic securitisation scheme or a traditional securitisation scheme as defined in the Securitisation Notice;

2.4. "securitisation notice" means the regulations contained in Government Notice 2 published in Government Gazette 30628 of 01 January 2008 issued in terms of the Banks Act and includes any amendment to the said regulations; and

2.5. "special purpose institution ("SPI") means a special purpose institution as defined in the Securitisation Notice.[1]

3. Introduction

3.1. In South Africa, securitisation schemes are currently regulated by the Securitisation Notice and Commercial Paper Notice which are administered by the South African Reserve Bank ("the SARB"). These Notices exclude securitisation schemes and the issuing of commercial paper from the definition of "the business of a bank"[2] in the Banks Act subject to certain regulatory conditions. It was decided in the early 1990's

[1] The Securitisation Notice defines "a special purpose institution" as a company or trust, insolvency remote, incorporated, created or used solely for the purpose of the implementation and operation of a traditional or synthetic securitisation scheme.

[2] The business of a bank is defined in section 1 of the Banks Act.

to regulate securitisation schemes by way of an exemption under the Banks Act.

3.2. The legal framework governing securitisation schemes has undergone several changes in response to developments in the financial markets. One of the principal objectives of regulating securitisation schemes was to address the monetary-policy and regulatory concerns prevailing during the early 1990s, namely, that the uncontrolled development of asset securitisation could harm a small open economy as a result of unrestrained disintermediation of the banking sector e.g. the securitisation of non-bank assets when not effected via a bank's balance sheet was disallowed. However, this policy was relaxed in 2001. The current Securitisation Notice applies to securitisation schemes entered into by banking as well as non-banking institutions.

3.3. To assist the Registrar of Banks in evaluating all relevant risk factors when considering an application in terms of the Securitisation Notice, the Registrar of Banks reviewed and amended its information requirements in respect of applications submitted to it and issued Directive 1/2012 on 23 January 2012 in terms of section 6(6) of the Banks Act. The purpose of the Directive is to require banks, controlling companies, eligible institutions and any other person to furnish specified information as part of future applications in terms of the Securitisation Notice.[3]

3.4. Consequently, it has become necessary to align the Commission's approach to securitisation schemes with the current legal framework governing securitisation schemes. This Update only deals with the application of merger provisions of the Competition Act to securitisation

[3] Applicants shall submit the proposed information sheet attached as Annexure A to the Directive, as part of each application submitted in respect of a new securitisation scheme in terms of the Securitisation Notice.

schemes. Issues such as risk that securitisation may pose to the soundness of financial institutions fall outside the scope of the Update.

3.5. In drafting this Update the Commission examined and considered the approach of various other jurisdictions to securitisation schemes and the possible negative competition and public interest impact that may arise from these transactions. The Commission also consulted with the SARB, as the banking regulator has concurrent jurisdiction with the Commission on banking transactions. This Update aims to articulate the approach the Commission is likely to take in respect of securitisation schemes involving banking and non-banking institutions who enter into transactions to mitigate their risks in the ordinary course of their business.

4. Securitisation Schemes

4.1. A securitisation scheme is defined as "a scheme whereby a special purpose institution issues commercial paper[4] and where the payments by the special purpose institution[5] in respect of the commercial paper so issued are made from the cash flows arising from or proceedings derived from the assets, consisting of claims sounding in money, transferred to such SPI by an originator,[6] remote originator[7] or repackager[8]."[9] The Securitisation Notice

[4] The Securitisation Notice defines "commercial paper" as (a) any written acknowledgement of debt, irrespective whether the maturity thereof is fixed or based on a notice period, and irrespective whether the rate at which interest is payable in respect of the debt in question is a fixed or floating rate; or(b) debentures or any interest-bearing written acknowledgement of debt issued for a fixed term in accordance with the provisions of the Companies Act; or preference shares, but does not include bankers' acceptances.

[5] The Securitisation Notice defines a "special purpose institution" as a company or trust, insolvency remote, incorporated, created or used solely for the purpose of the implementation and operation of a traditional or synthetic securitisation scheme. In turn "insolvency remote" is defined as follows: "in respect of a special purpose institution means that the assets of such a special purpose institution shall not be subject to any claim of an institution – (a) transferring assets in terms of a traditional securitisation scheme; or (b) transferring risk in terms of a synthetic securitisation scheme, to the special purpose institution, as a result of such a transferring institution's insolvency.

[6]The Securitisation Notice defines an "originator" as follows: "in relation to –(a) a traditional securitisation scheme means an institution that, whether at the commencement or during the life

draws a distinction between two securitisation schemes – a traditional securitisation scheme and a synthetic securitisation scheme.

4.1.1 A traditional securitisation scheme is defined as a scheme whereby a SPI -

(a) issues commercial paper to investors; and

(b) uses the proceeds of such issue primarily to obtain or invest in assets; and

(c) makes payment primarily-

(i) in respect of the commercial paper so issued; or

(ii) to an institution acting in a secondary role,[10] which payments are made from-

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of the traditional securitisation scheme, transfers assets from its own balance sheet, which assets are assets other than national Government securities or qualifying items, in terms of a traditional securitisation scheme; (b) a synthetic securitisation scheme means an institution that, whether at the commencement or during the life of the synthetic securitisation scheme, uses a credit-derivative instrument to transfer the risk associated with a specified pool of assets, other than national Government securities or qualifying items, to investors without actually selling the assets (c) an asset-backed commercial paper programme means an institution that serves as a sponsor in respect of the programme that acquires exposures other than from the sponsor's own balance sheet, provided that when (i) the assets, other than national Government securities or qualifying items, referred to in paragraph (a) above; or the risk associated with a specified pool of assets, other than national Government securities or qualifying items, referred to in paragraph (b) above, constitute 10 percent or less of the total assets or risks transferred, such an institution shall for purposes of this Schedule be regarded as – (A) a repackager; or (B) when such an institution also acts as a sponsor in respect of the same securitisation scheme, as a sponsor.

[7] The Securitisation Notice defines a "remote originator" as an institution that directly or indirectly lends money to a special purpose institution in order for the special purpose institution to take transfer of assets in terms of a traditional securitisation scheme or risk in terms of a synthetic securitisation scheme.

[8] The Securitisation Notice defines a "repackager" as an institution that, whether at the commencement or during the life of a traditional or synthetic securitisation scheme, acquires and subsequently – (a) transfers the assets; or (b) transfers the risk relating to assets, consisting of national Government securities or qualifying items of third parties via its balance sheet in terms of a traditional or synthetic securitisation scheme: Provided that an institution that, whether at the commencement or during the life of the traditional or synthetic securitisation scheme, acquires and subsequently transfers the assets or risk(s) relating to assets, consisting of assets other than national Government securities or qualifying items to third parties via its balance sheet in terms of the said traditional or synthetic securitisation scheme, shall for purposes of this Schedule be regarded as an originator.

[9] Banks Act Circular 5/2003.

[10] The Securitisation Notice defines "secondary role" as the participation by an institution in a traditional or synthetic securitisation scheme, as a provider of a credit-enhancement facility, a provider of a liquidity facility, an underwriter, a purchaser of senior commercial paper, a servicing agent or a counterparty to a transaction included in the trading book of a bank.

(A) the cash flows arising or proceeds derived from the assets transferred to such a SPI by an originator or repackager;

(B) the cash flows arising or proceeds derived from assets in which the SPI invested; or

(C) facilities granted to the SPI by an institution in accordance with the provisions of this Schedule.

4.1.2 A synthetic securitisation scheme is defined as a scheme whereby a SPI-

(a) issues commercial paper to investors; and

(b) uses the proceeds of such issuance primarily to obtain -

(i) credit-risk exposure relating to-

(A) an underlying asset;

(B) a reference entity; or

(C) a reference asset, through the use of funded or unfunded credit-derivative instruments or guarantees, and

(ii) assets serve as collateral; and

(c) makes payment primarily-

(i) in respect of commercial paper to issued; or

(ii) to an institution acting in a secondary role, which payment are made from-

(A) the cash flows arising from the assets that serve as collateral; and

(B) the fees and/or premium paid to the SPI by an institution acting as an originator, remote originator or repackager.

4.2 In a securitisation scheme, an institution may act in “primary role” (an originator, remote originator, sponsor or a repackager) or a “secondary role” (a provider of a credit-enhancement facility, a provider of a liquidity facility, an underwriter, a purchaser of senior commercial paper, a servicing agent or a counter-party to a transaction included in the trading book of a bank).

4.3. The Securitisation Notice comprehensively sets out conditions governing both traditional and synthetic securitisation schemes:

Traditional securitisation scheme

4.3.1. In terms of paragraph 4(1)(a) of the Securitisation Notice normally (i) a traditional securitisation scheme is likely to involve the legal and economic transfer of assets to; or assets legally and economically acquired by, a special purpose institution that issues commercial paper that are claims against the said assets transferred or acquired; (ii) different classes of commercial paper are issued, and each class has a different priority claim on the cash flows originating from the underlying pool of assets; (iii) the junior or subordinated risk positions can absorb losses without interrupting contractual payments to more senior tranches; and (iv) the potential risk of loss for the investors in commercial paper issued by the special purpose institution primarily depends upon the performance of the underlying assets obtained by the special purpose institution. Paragraph 4(2)(a) of the Securitisation Notice requires that the transfer of assets to or acquisition of assets by a special purpose institution should totally divest the transferring institution and all its associated companies of all rights and obligations originating from the underlying transactions and all risks in connection with the assets transferred or acquired subject to certain provisos.

4.3.2. The provisions of paragraph 4(2)(b) require that the transferor shall not maintain any effective or indirect control over the assets transferred to a special purpose institution, that is, the assets shall be legally isolated from the institution that transferred the assets in such a way that the assets and the benefits that relate to the assets shall be placed beyond the reach of the institution that transferred the assets, and its creditors,

even in the event of bankruptcy or liquidation subject to certain provisos. In terms of paragraph 4(2)(e) of the Securitisation Notice, investors who invest in commercial paper issued by the special purpose institution shall only have a claim in respect of the underlying pool of assets transferred and shall have no claim against the institution transferred the assets. Paragraph 4(2)(p) contains clauses aimed at preventing an institution acting in a primary role (e.g. originator or sponsor) from acquiring a controlling interest in the special purpose institution, and paragraph 4(2)(q) states that the board of directors or body of trustees, as the case may be, of a special purpose institution shall be independent of the institution acting in a primary role subject to certain provisos.[11]

Synthetic securitisation scheme

4.3.3. In terms of paragraph 5(1) of the Securitisation Notice, normally, (i) a synthetic securitisation scheme refers to a transaction whereby an institution uses a credit-derivative instrument to transfer the risk association with a specified pool of underlying assets, reference entities or reference assets to a special purpose institution, which risk is stratified into no less than two risk positions that reflect different degrees of credit risk; (ii) the junior or subordinated risk positions can absorb losses without interrupting contractual payments to more senior tranches; (iii) the potential risk of loss for the investors in commercial paper issued by the SPI primarily depends upon the performance of the underlying risk exposures obtained by the SPI; (iv) the packaging of risk relating to multiple underlying assets, reference assets or reference entities for transfer creates risks that are more complex than those for a single asset or a few assets; (v) there will

[11] In terms of the Securitisation Notice, "primary role" means the participation by an institution in a traditional or synthetic securitization scheme as an originator, remote originator, sponsor or a repackager.

tend to be substantially higher loss severity for lower rated tranches in a synthetic securitisation scheme than for higher rated tranches. Within a synthetic securitisation structure, investors in junior tranches will suffer a total loss before the investors in more senior tranches incur any loss.

4.4. The provisions aimed at preventing an institution acting in a primary role from acquiring a controlling interest in and ensuring the independence of the SPI, also apply to a synthetic securitisation scheme. A bank, acting in a primary role, may repurchase assets from the SPI so long as the repurchase will not result in over 10 per cent of the assets being held by such bank. The Registrar of Banks may, in its sole discretion, allow a bank to repurchase risk relating to assets in excess of this limitation[12].

5. The effect of the merger provisions of the Competition Act 89 of 1998, as amended (the "Act")

5.1. Section 12(1)(a) of the Competition Act defines a merger as occurring when one or more firms directly or indirectly acquire or establish direct or indirect control over the whole or part of the business of another firm. Such mergers may be achieved in any manner, including through the purchase or lease of shares, acquisition of an interest or assets of the other firm in question, or amalgamation or other combination with the other firm in question. The merger may not be implemented unless and until it has been approved by the competition authorities[13].

5.2. In a securitisation scheme, the transfer of assets to the SPI, as envisaged in the Securitisation Notice, may result in the SPI acquiring control over "part of the business of another firm" (the transferor) within the

[12] Paragraph 4(2)l)(iv)
[13] Section 13A(3) of the Act.

contemplation of section 12(1) of the Competition Act. This transfer may therefore constitute a merger as contemplated in section 12 of the Competition Act.[14] Where the threshold requirements are met, notification of these transactions would be required. If the SPI has no assets except those acquired as a result of the transaction, this will be considered in the calculation of the annual turnover or asset values of the firms to the transaction for the purpose of determining the threshold.

5.3. In securitisation schemes generally the firm acting as an originator, may pool assets from its own portfolio. However, it may securitise assets that have previously been purchased or acquired from a third party. In the latter instance, merger notification may be triggered twice in respect of the same pool of assets, provided the thresholds are met: firstly, when the firm acquires the pool of assets from the third party and secondly, when the firm then transfers the same pool of assets to a SPI.

5.4. The definition of a merger in the Competition Act does not expressly allow for a consideration of the rationale or intention behind transactions and these are not relevant for notification purposes. However, it could not have been the intention of the legislature to include risk mitigation transactions, entered into within the ordinary course of business, within the ambit of the merger provisions.

5.5. Thus, in the application of the Competition Act, consideration ought to be given to transactions that are purely financial in nature and occur in order to mitigate the inherent risks in the ordinary course of business by banking and non-banking institutions providing finance.

5.6. In view of the nature of securitisation schemes, the Commission is likely to be burdened with numerous notifications in instances where there are no

[14] See *Competition Commission V Edgars Consolidated Stores Limited 95/FN/Dec02*.

real competition and/or public interests concerns. The approach adopted considers the nature and purpose of securitisation schemes, current global economic environment, as well as the approach adopted in other jurisdictions.

6. The Commission's approach

6.1. The Commission does not wish to burden itself and the parties involved in such agreements in regulating transactions that could not have been intended to fall within the ambit of the Competition Act. While the execution of these transactions technically falls within the ambit of the definition of a merger, it could not have been the intention of the legislature to enforce competition regulation on purely financial, risk mitigation transactions. It would, however, not be prudent to adopt an approach that would ultimately encourage evasion of the Competition Act by parties who intentionally structure transactions in this manner.

6.3. Furthermore, cognizance ought to be given to the fact that a SPI is established solely for purposes of executing a transfer of risk. In terms of the Securitisation Notice, a SPI is created solely for the purpose of the implementation and operation of a traditional or synthetic securitisation scheme. The limitations imposed on the SPI ensure that it does not enjoy a competitive position. Thus, it is unlikely that the execution of these schemes would have any impact on competition, particularly since a SPI is not intended to be a regular business entity.

6.4. Thus, in respect of traditional and synthetic securitisation schemes outlined above the Commission would not require notification of the transaction where a bank or non-banking institution transfers a portfolio of assets to a SPI, provided that the scheme is executed in compliance with

the Securitisation Notice. This approach would not apply to any further disposal of the same portfolio of assets.

6.5. This approach would be a significant step in line with the international trend to exempt these transactions from merger notification. However, the Commission reserves the right to review such transactions, particularly if any competition or public interest concerns arise.