


Asset-Backed Securities

**Asset-Backed Securities:
Legal and Regulatory Issues**

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**Asset-Backed Securities:
Legal and Regulatory Aspects**

- Legal
 - ◆ The Transfer
 - ◆ The Special-Purpose Vehicle
- Taxation
- Accounting Treatment
- Bank Regulatory Treatment

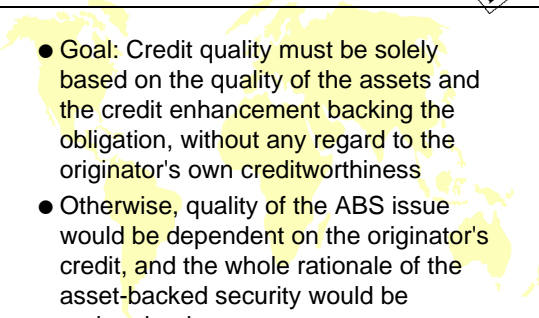


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Legal Aspects

LEGAL

- Goal: Credit quality must be solely based on the quality of the assets and the credit enhancement backing the obligation, without any regard to the originator's own creditworthiness
- Otherwise, quality of the ABS issue would be dependent on the originator's credit, and the whole rationale of the asset-backed security would be undermined.

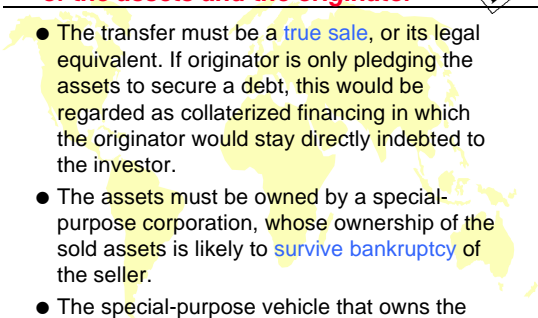


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Three conditions enable the separation of the assets and the originator

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- The transfer must be a **true sale**, or its legal equivalent. If originator is only pledging the assets to secure a debt, this would be regarded as collateralized financing in which the originator would stay directly indebted to the investor.
- The assets must be owned by a special-purpose corporation, whose ownership of the sold assets is likely to **survive bankruptcy** of the seller.
- The special-purpose vehicle that owns the assets must be **independent**



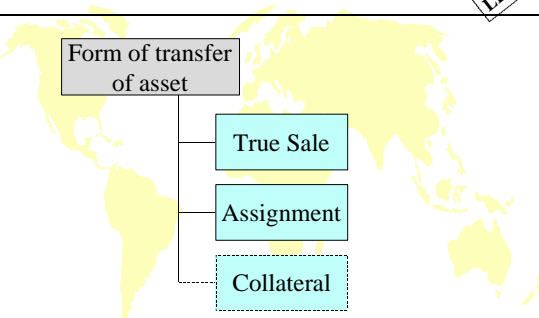
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The Form of Transfer: True Sale?

LEGAL

Form of transfer of asset

- True Sale
- Assignment
- Collateral

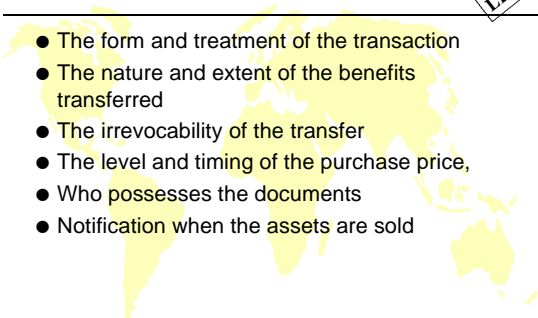


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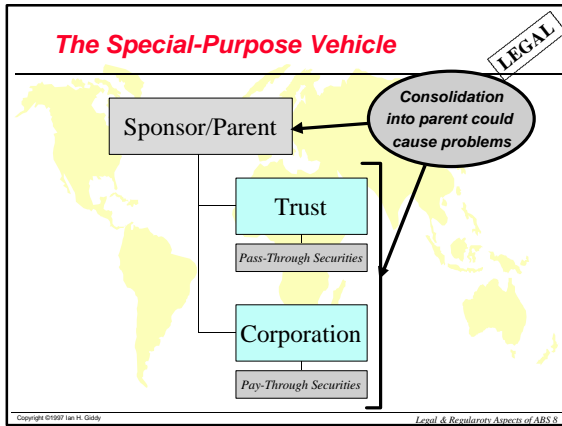
What Makes it a Sale?

LEGAL

- The form and treatment of the transaction
- The nature and extent of the benefits transferred
- The irrevocability of the transfer
- The level and timing of the purchase price,
- Who possesses the documents
- Notification when the assets are sold

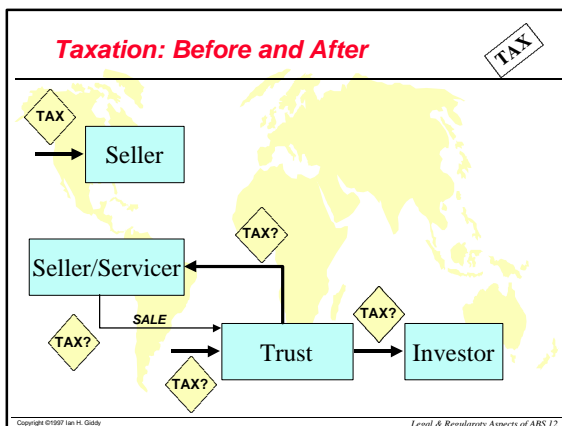
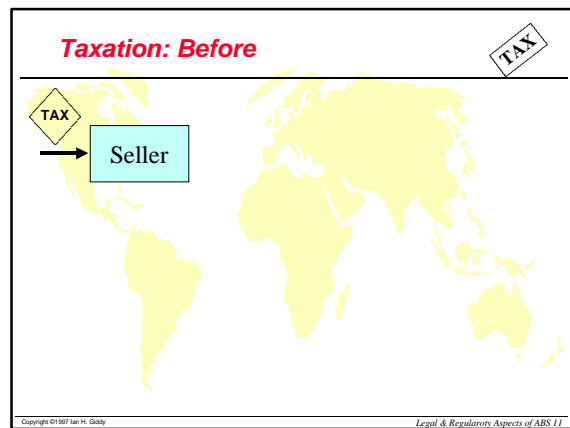


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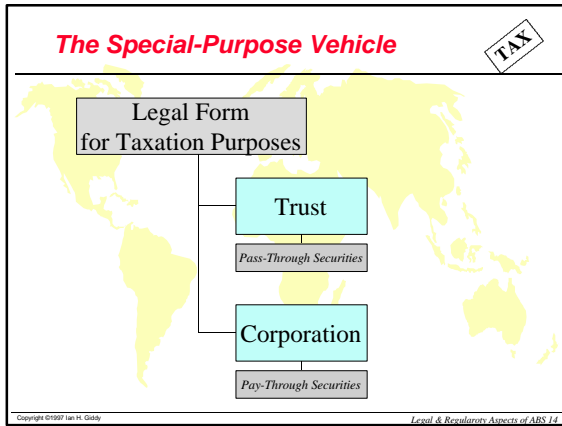


- ### What Makes it Likely to be Consolidated?
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- The difficulty of segregating and ascertaining individual assets and liabilities
 - The presence or absence of consolidated financial statements
 - The comingling of assets and business functions
 - The existence of parent and intercorporate guarantees and loans
 - The transfer of assets without strict observance of corporate formalities.
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- ### Taxation Aspects
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- If the SPV or the transfer is subject to normal corporate, withholding, or individual tax rates, investors or borrowers could in principle be subject to additional or double taxation
- Must avoid double taxation of*
- Seller/servicer
 - Trust or special-purpose corporation
 - Investors
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- ### Taxation of Seller/Service
-
- Is the transaction a sale?
 - ◆ If so, it may entail a profit or loss that must be recognized in the seller's taxable income. It may also attract stamp duty.
 - After the sale the servicer will reap revenues, including origination or servicing fees
 - ◆ Hence the ongoing costs of the securitization should be recorded as a deduction for tax purposes
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Taxation of SPV: Pass-Through Certificates Owned by a Trust TAX

- Pass-throughs are ownership certificates, generally issued by a "trust"
- A trust is a conduit between the assets and their owners and therefore is not considered a taxable entity.
- Investors are taxed as if they held undivided ownership interests in the financial claims held by the trust.

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Trust Criteria TAX

- A trust is a passive entity
 - ◆ The trustee may only perform ministerial activities and should be prevented from entering into any course of business, especially profitable business
- A trust cannot have more than one class of ownership interest
- The trust assets must be fixed

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Pay-through securities issued by a special-purpose corporation TAX

- Corporation can issue debt securities with different characteristics (such as interest rate levels and maturities)
- A pay-through bond is a debt obligation, paying interest which is taxable and tax deductible
- SPV must be carefully structured so that its income is offset by expenses so that little or no taxes are incurred

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Accounting Treatment ACCOUNTING

- Sale versus financing
- Consolidation
- Accounting for loan servicing

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FASB Sale Treatment ACCOUNTING

- The transferor relinquishes control of the future economic benefits embodied in the assets being transferred
- The SPV cannot require the transferor to repurchase the assets except pursuant to certain recourse provisions
- The transferor's obligation under any recourse provision are confined and can be reasonably estimated

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Consolidation Treatment

ACCOUNTING

- International accounting standards hold that consolidated financial statements are more meaningful than separate ones
- "Nonhomogeneous operation" exception
- Finance, insurance, real estate and leasing subsidiaries can generally be left apart

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Fees

ACCOUNTING

- Loan-origination fees. These are deferred and recognized over the life of the loan as an adjustment of yield.
- Commitment fees. These are to be deferred.
- Syndication fees. These should be recognized when the syndication is complete unless the originator retains a portion of the syndicated loan.

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Bank Regulation and Capital Requirements

- *Goal: Ensure that the substance and not the form of the asset transfer is what governs capital requirements.*

The regulatory authorities may assess capital or reserve requirements as if the financing was a secured borrowing:

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Bank Regulation and Capital Requirements

- *Goal: Ensure that the substance and not the form of the asset transfer is what governs capital requirements.*

The regulatory authorities may assess capital or reserve requirements as if the financing was a secured borrowing:

- ◆ Where the transfer leaves the bank open to recourse deemed risky by the authorities,
- ◆ Or where there is potential for a "moral hazard" whereby a bank may shore up potential or actual losses in the sold assets to protect its name even when not legally required to do so.

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Bank Regulation: Issues in Asia

- *Avoid excessive bank risk-taking*
- *Discourage speculative investments*
- *Prevent financial market scandals*
- *Prevent circumvention of deposit regs*
- *Encourage financing of capital investment*
- *Discourage financing of consumption*
- *Promote development of capital markets*

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Case Study: Ford Credit Owner Trust 1998-B

- What is the legal structure of this deal?
- What are the different classes of securities, and their terms?
- How is the SPV taxed?
- Is it a pass-through or a pay-through?
- Can you quantify the benefits or costs to the borrower?

Group work

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**Case Study:
Ford Credit Owner Trust 1998-B**

- What is the legal structure of this deal?
- What are the different classes of securities, and their characteristics?
- How is the SPV structured?
- Is it a true sale or a pay-through?
- How do you quantify the benefits or costs to the issuer?

See Excel Spreadsheet
abs cost-benefit.xls

Group work

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