**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**

- **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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**The Form of Transfer: True Sale?**

- **Form of transfer of asset**
  - True Sale
  - Assignment
  - Collateral

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**What Makes it a Sale?**

- 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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**Three conditions enable the separation of the assets and the originator**

- 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.
The Special-Purpose Vehicle

- Sponsor/Parent
- Trust
- Corporation

Consolidation into parent could cause problems

What Makes it Likely to be Consolidated?

- 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.

Taxation Aspects

- 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

Taxation: Before

- Seller

Taxation: Before and After

- Seller/Servicer
- Trust
- Investor

Taxation of Seller/Servicer

- Is the transaction is 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
Legal Form for Taxation Purposes

- Trust
  - Pass-Through Securities
- Corporation
  - Pass-Through Securities

Trust Criteria
- 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

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

Accounting Treatment
- Sale versus financing
- Consolidation
- Accounting for loan servicing

FASB Sale Treatment
- 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

Taxation of SPV: Pass-Through Certificates Owned by a Trust
- 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.
Consolidation Treatment

- 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.

Fees

- 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.

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.

Bank Regulation: Issues in Asia

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

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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Group work

See Excel Spreadsheet: cost-benefit.xls

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