

Asset-Backed Securities

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

Prof. Ian Giddy  
Stern School of Business  
New York University

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

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

### ***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.

Copyright ©2000 Ian H. Giddy

Legal & Regulatory Aspects of ABS 4

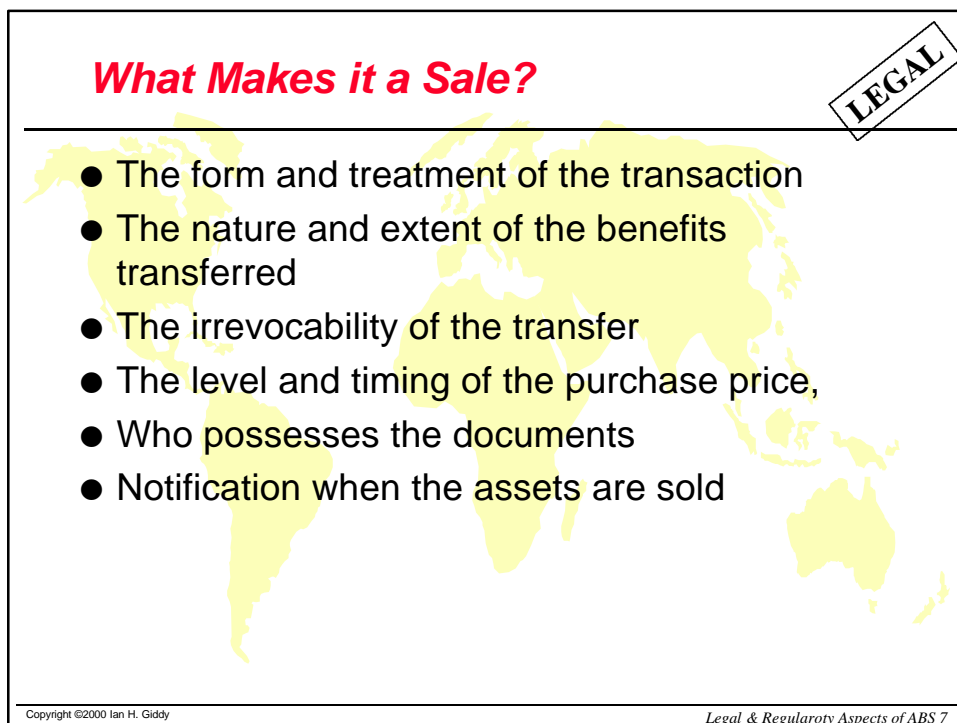
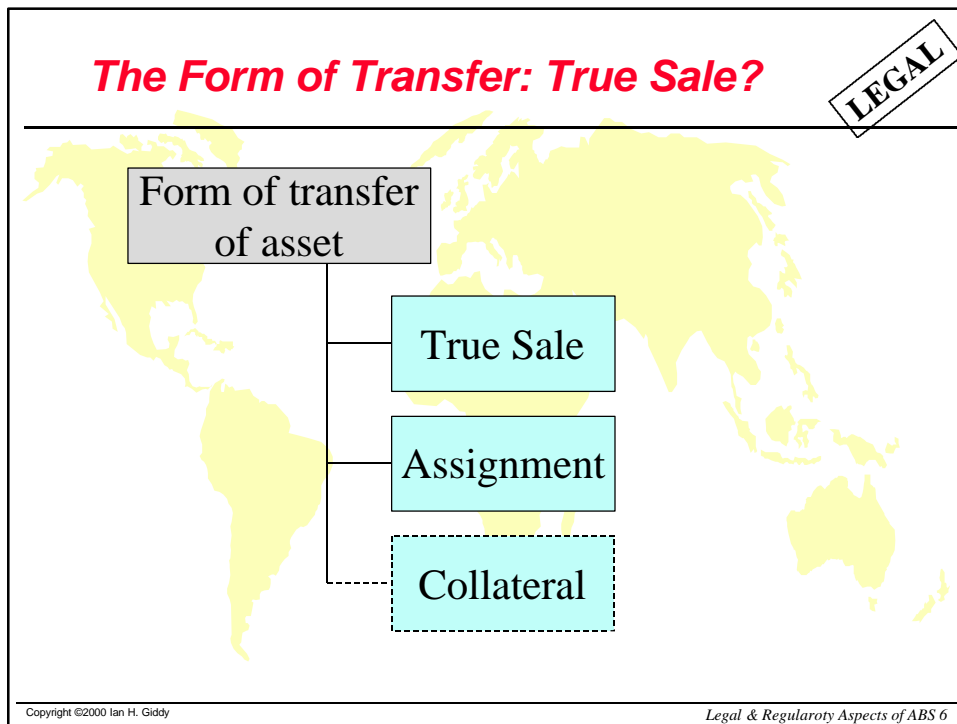
### ***Three conditions enable the separation of the assets and the originator***

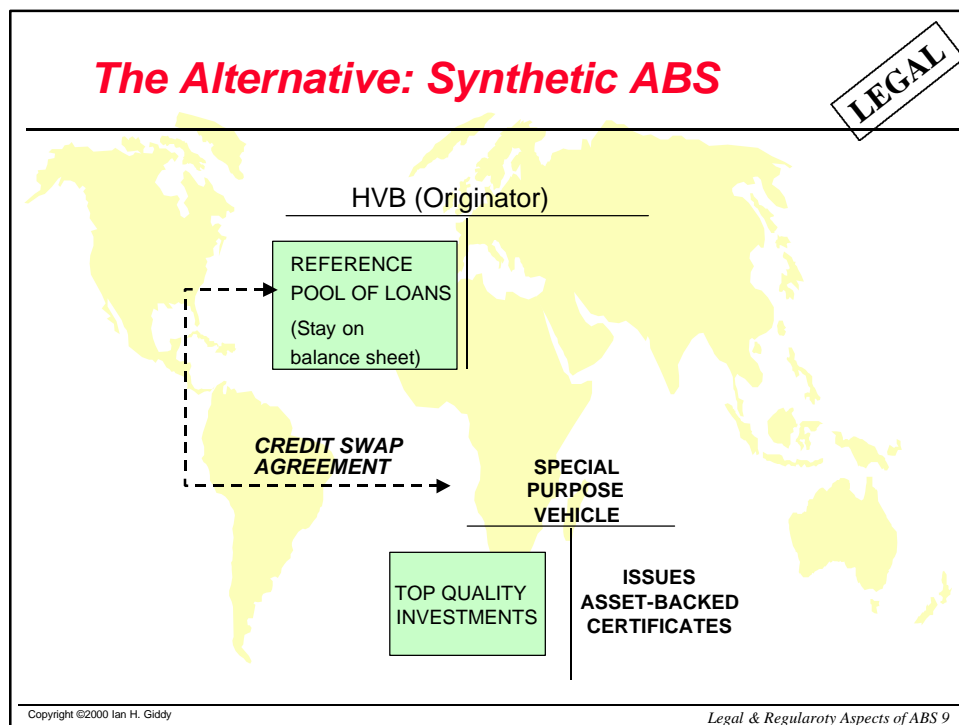
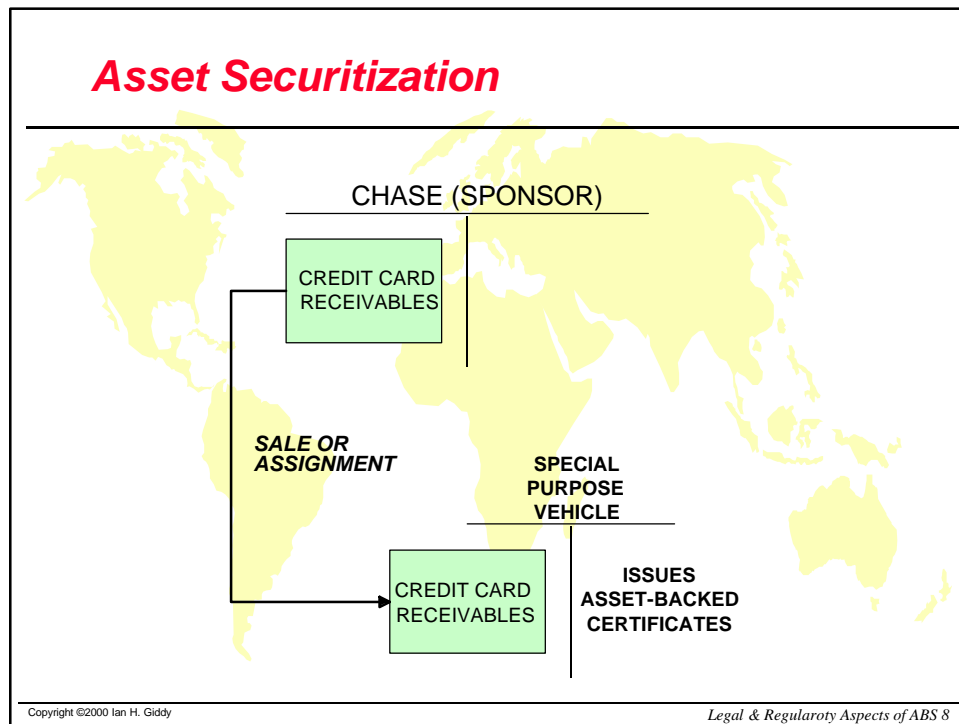
**LEGAL**

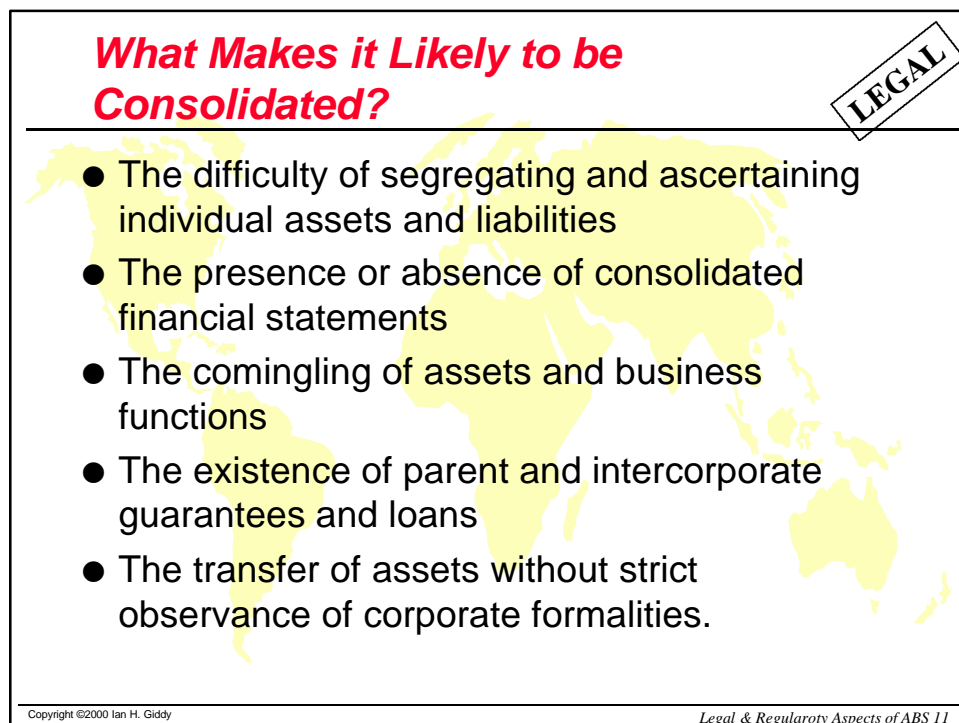
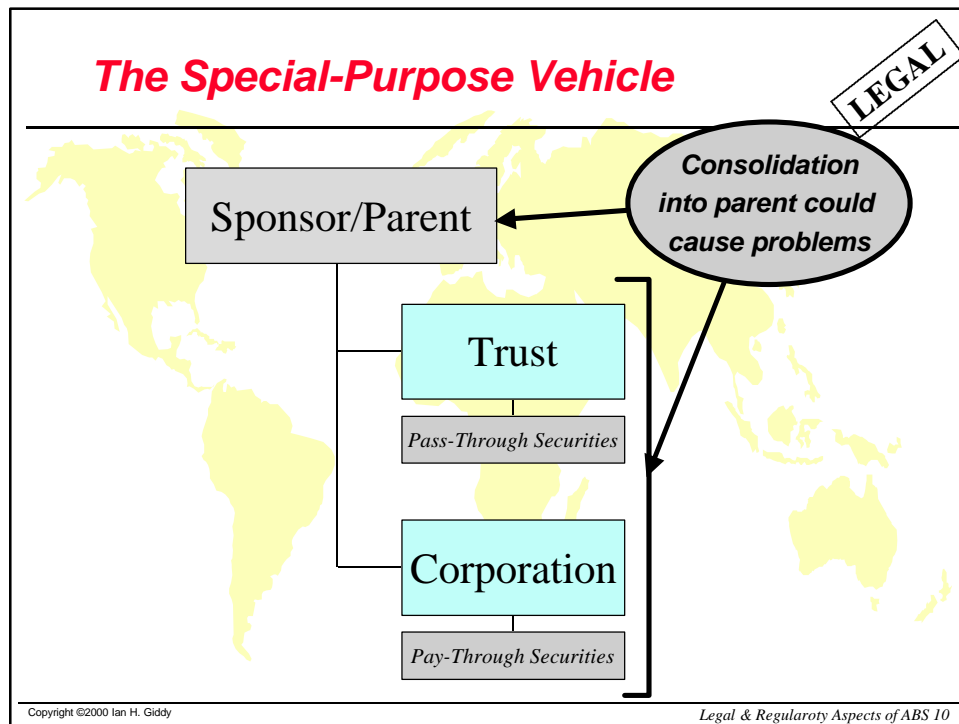
- The transfer must be a **true sale**, or its legal equivalent. If originator is only pledging the assets to secure a debt, this would be regarded as collateralized financing in which the originator would stay directly indebted to the investor.
- The assets must be owned by a special-purpose corporation, 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**

Copyright ©2000 Ian H. Giddy

Legal & Regulatory Aspects of ABS 5







## ***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

Copyright ©2000 Ian H. Giddy

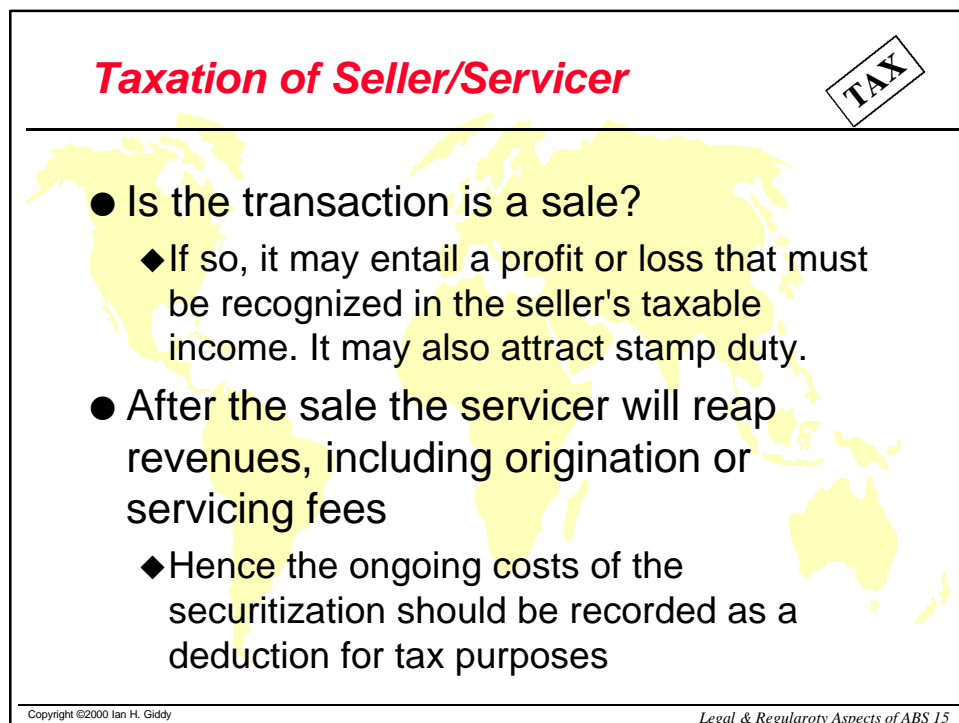
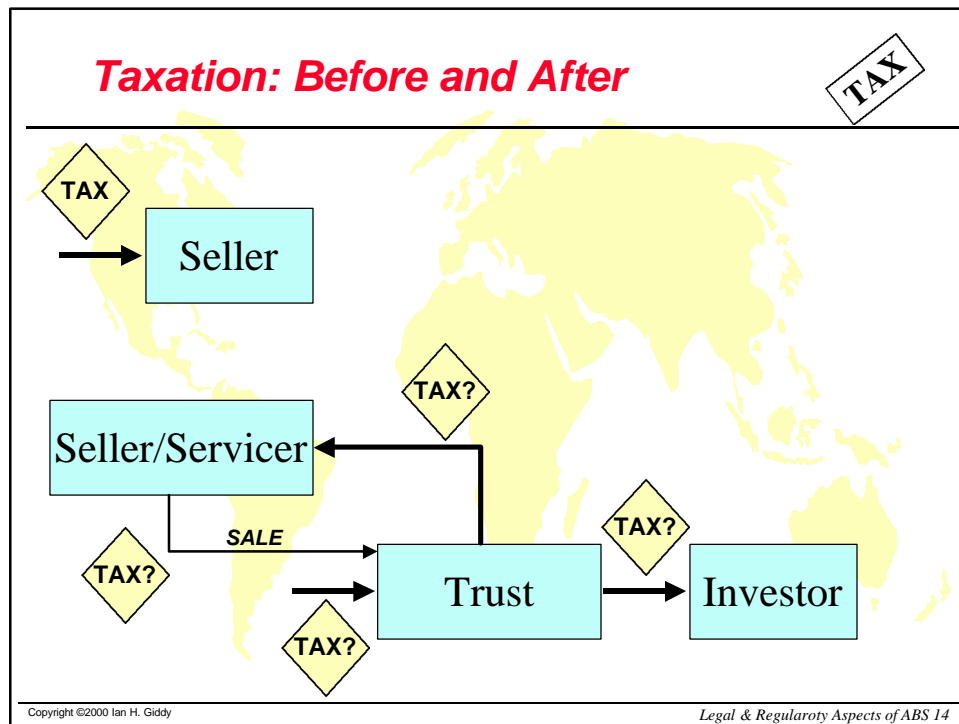
Legal & Regulatory Aspects of ABS 12

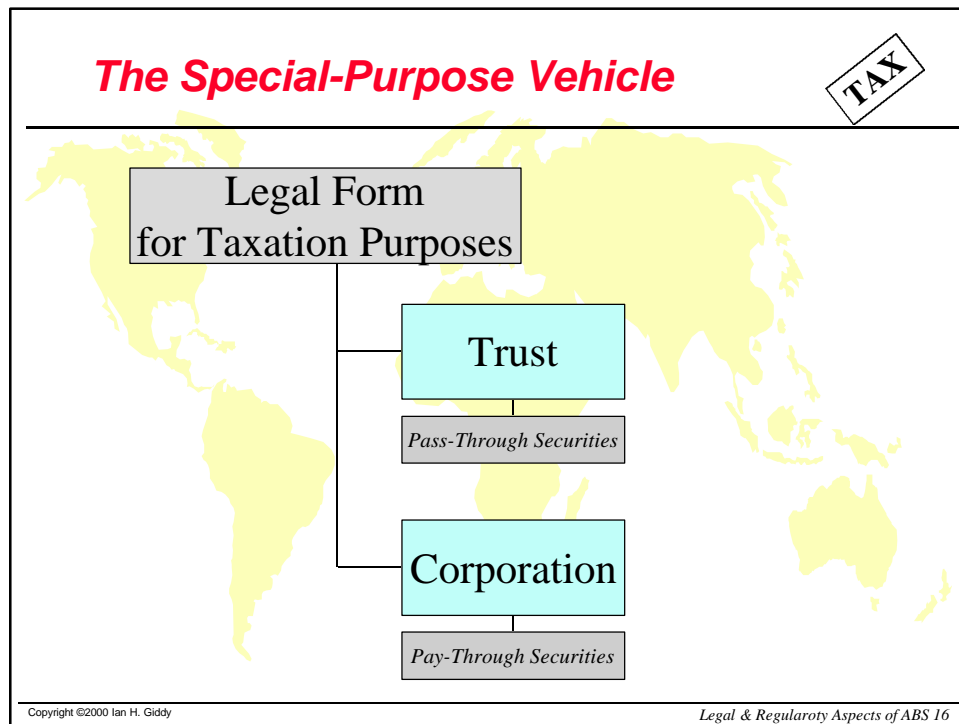
## ***Taxation: Before***



Copyright ©2000 Ian H. Giddy

Legal & Regulatory Aspects of ABS 13





### ***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.

Copyright ©2000 Ian H. Giddy

*Legal & Regulatory Aspects of ABS 17*



### **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

ACCOUNTING

Copyright ©2000 Ian H. Giddy

Legal & Regulatory Aspects of ABS 20

## ***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

ACCOUNTING

Copyright ©2000 Ian H. Giddy

Legal & Regulatory Aspects of ABS 21

## **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

Copyright ©2000 Ian H. Giddy

Legal & Regulatory Aspects of ABS 22

## **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.

Copyright ©2000 Ian H. Giddy

Legal & Regulatory Aspects of ABS 23

## **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:

## **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 regs*
- *Encourage financing of capital investment*
- *Discourage financing of consumption*
- *Promote development of capital markets*

Copyright ©2000 Ian H. Giddy

*Legal & Regulatory Aspects of ABS 26*

## ***Issues in Malaysia***

Negara is reportedly considering detailed guidelines on securitization to clarify the gray areas and give the required boost to ABS market

### ***Sale or assignment of assets***

- The Malaysian legal system is largely based on the English common law. Sec. 4 (3) of Malaysian Civil Law Act, 1956 requires that the assignment of a debt be notified to the debtor. Since this is not mostly practical, the alternative is equitable assignment.

### ***Consolidation in the event of bankruptcy***

- As usual with most countries, the Malaysian companies law contains provisions for avoiding a transfer made in contemplation of bankruptcy. This, however, can be resolved by establishing that the transfer took place at fair values.

### ***Taxation***

- There is a stamp duty implication of 4% on transfer of receivables. Current practice is to defer the duty implication by executing and keeping outside the country the deed of assignment. This would however lead to stamping when the SPV has to file a suit against the obligor for enforcement.
- A withholding tax of 15% is applicable on interest payments to non-resident persons. Normal practice for Malaysia is to incorporate the SPV in Labuan, an offshore financial centre, in which case the withholding tax is not applicable.

### ***Exchange controls***

- In case of an offshore SPV, numerous exchange control issues will also arise - the Malaysian Exchange Control Act 1953 will be applicable

### ***Accounting***

- Specific accounting standards have not yet been established

Copyright ©2000 Ian H. Giddy

*Legal & Regulatory Aspects of ABS 27*

### ***What is Equitable Assignment?***


Assignment of receivables, that is, transfer of a debt, can either be full fledged legal transfer or can be a transfer not documented as a legal transfer but recognised by Courts as an effective transfer for purposes of enforcement. "Equity" means fairness, that is, to meet the ends of justice. In English law, there were separate Courts of Equity, which would deal with equitable claims. In present day legal system, equity Courts do not exist: yet, Courts do follow principles of equity to enforce claims which are otherwise not contractually enforceable.

### ***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?

***globalsecuritization.com***

---



Ian H. Giddy  
Stern School of Business  
New York University  
44 West 4th Street, New York, NY 10012, USA

Tel 212-998-0332; Fax 917-463-7629  
[ian.giddy@nyu.edu](mailto:ian.giddy@nyu.edu)  
<http://giddy.org>