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
**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.

**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 Form of Transfer: True Sale?

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

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
**Asset Securitization**

CHASE (SPONSOR)

CREDIT CARD RECEIVABLES

SALE OR ASSIGNMENT

SPECIAL PURPOSE VEHICLE

CREDIT CARD RECEIVABLES

ISSUES ASSET-BACKED CERTIFICATES

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**The Alternative: Synthetic ABS**

HVB (Originator)

REFERENCE POOL OF LOANS
(Stay on balance sheet)

CREDIT SWAP AGREEMENT

SPECIAL PURPOSE VEHICLE

TOP QUALITY INVESTMENTS

ISSUES ASSET-BACKED CERTIFICATES

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The Special-Purpose Vehicle

- Sponsor/Parent
  - Trust
    - Pass-Through Securities
  - Corporation
    - Pay-Through Securities

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**
- **Sellers/Servicer**
- **Trust**
- **Investor**

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**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
**The Special-Purpose Vehicle**

- **Legal Form for Taxation Purposes**
  - Trust
    - Pass-Through Securities
  - Corporation
    - Pay-Through Securities

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

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
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?