Truth of True Sales: An analysis of securitisation structures

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Essential securitisation process

Traditional framework

Securitisation framework

Bank

Mortgages

Origination

Credit enhancement

Funding

Servicing

Equity

Debt

Public Savings

Bank

Mortgages

Origination

Credit enhancement

Servicing

Equity

Debt

Public Savings

Class A

Class B

Retained class

SPVs

Mortgage-backed Securities

Public Savings

Debt

Equity

Traditional framework

Securitisation framework

Mortgages

Bank
The essential securitisation structure: isolation of assets

**Concept of a true sale:**
- A sale which is “true”
- Meaning, the fear, that the sale is a simple make-believe, is not justified
  - Fear arises because:
    - Risks, particularly at first loss level, are originator-retained
    - Rewards, by way of excess spreads, are recaptured
      - I.e., from risk-rewards perspective, no significant change in the originator’s position

**Questions on the truth of the sale:**
- Classical cases: Major’s Furniture Mart, Evergreen Valley
- Recent challenge: LTV Steel
- Unsuccessful challenge: B C Tel’s case (Canadian ruling)

**Has the true sale method been working fine?**
- Mixed experience so far

**True sales in securitisation transaction:**
- The heart of securitisation is not true sale, but bankruptcy-risk mitigation
  - True sale is only means-to-an-end
  - Consequential factors like balance-sheet derecognition, capital relief or gain stripping are all by-products of the process
The bankruptcy-risk and various forms of funding

- The key risk in financing is the bankruptcy-risk
- Bankruptcy = assets – liabilities < 0
  - The difference is to be equitably distributed to various claims and interests
  - In typical bankruptcy administration, the difference is allocated in a hierarchy of claims:
    - Over-riding preference (employees’ claims, etc)
    - Claims of secured creditors (if the choose not to enforce security interests)
    - Preferential creditors
    - Claims of floating charge holders
    - Unsecured lenders
  - A secured creditors’ interest in English common law is a real interest; collateralized by claim against the borrower
    - Jus in rem versus jus in personam
    - Secured lender may enforce security interest outside of bankruptcy process; leave of Court is a mere procedural requirement
Key difference between US and Common law insolvency regime

- The US bankruptcy law provides for automatic stay on initiation of bankruptcy proceedings [sec. 362, Bankruptcy code]
- On the contrary, UK and common law insolvency codes provide for bankruptcy-remote security interest enforcement:
  - Hong Kong law supports the same view – Lord Templeman’s categorical ruling in *Downsview Nominees v First City Corporation* (1993) AC 295
  - True sales are more significant in US law than in UK law:
    - S&P (Ian Bell’s) article on why true sales are not the heart of European securitisation
- While secured lending may theoretically be bankruptcy remote, the lender’s right is still the right of a lender, not owner:
  - There might be pilferages:
    - For example, overriding preferences
    - Inefficiency of the legal/judicial system on enforcement of security interests
  - Question – if the security enforcement system was efficient, would be still need true sales?
- Therefore, the true sale method is still the most preferred way:
  - Though secured loan structures are common in the UK, it requires quite sophisticated analysis to give asset-backed ratings in secured loan transactions
What the true sale device does: positives

Off balance sheet treatment of assets:
- Is this the purpose of *fait accompli*?
- The purpose is not off balance sheet, but balance sheet netting
  - The purpose is leverage
    - Capital relief for banks, debt/equity relief for corporates, and non-borrowing accounting for governments
  - Off balance sheet is the result of assets having been put beyond reach of bankruptcy court:
    - If the same effect can be achieved in secured lending, similar accounting treatment should follow

Gain on sale booking or excess interest stripping:
- More of a malaise, than a merit of off-balance sheet accounting

Capital relief:
- More an effect of risk reduction:
  - Economic capital consequences may be the same in on-balance sheet or off-balance sheet assets
What the true sale device does: negatives

- Artificial transformation of the bank from owner to servicer:
  - Change of the role takes away the discretion of the originating bank in dealing with the obligor:
    - Immense difficulty in real life situations
  - Artificial, and often, questionable ways of sweeping the excess profit

- Artificial, unsubstantive entity to hold assets:
  - Special purpose vehicles have no commercial substance
  - Are not in any substantive business
  - Have purely nominal legal capital:
    - Therefore, the true capital is the residual beneficial interest, mostly with the seller
      - In other words, the seller is making a sale to his own sub-set

- Upfronting of gains on sale, and hence, taxes
- Transfer of prepayment risk/irregular cashflows
- Complicated documentation
- Uncertainty of true sale treatment
- Frictions and costs:
  - Obligor notification
  - Documentation/stamp duty costs, etc
The market has been exploring alternatives

Synthetic structures:
- Cashflows are replicated without a true sale:
  - Bankruptcy remoteness remains a problem
- Combination of synthetic and cash structures:
  - Risk transfers by synthetic transfers, and funding by straight balance sheet bonds:
    - Rating upliftment is still not guaranteed
    - Can we isolate the first loss support to a pool, if not isolate the pool?

Secured loan structures:
- Commonly used in several European transactions
  - Marne et Champagne transaction
  - Several other whole business deals
- Floating interest created because of the nature of the securitisation
  - In specific asset securitisation, can security interest creation work?
    - The world is moving towards more efficient security interest enforcement laws

Equitable transfers:
- Close to secured loans, as the transfer is unperfected
Isn’t there a better way of doing it?

- True sales evolved as a bankruptcy-proofing device
- The world of law has to evolve to meet the needs of commerce:
  - If the purpose of investing fraternity is to have entity-proof lending, is it necessary to sell assets?
- Conventional means:
  - Secured lending or mortgaging
  - Trusteeship
- New possible structures:
  - Multiple cell entities, or protected cell companies
  - Creating isolated pools within an entity, without need to sell assets
  - Call options, or contingent perfection of the sale