

Truth of True Sales: An analysis of securitisation structures

Vinod Kothari

1012 Krishna

224 AJC Bose Road

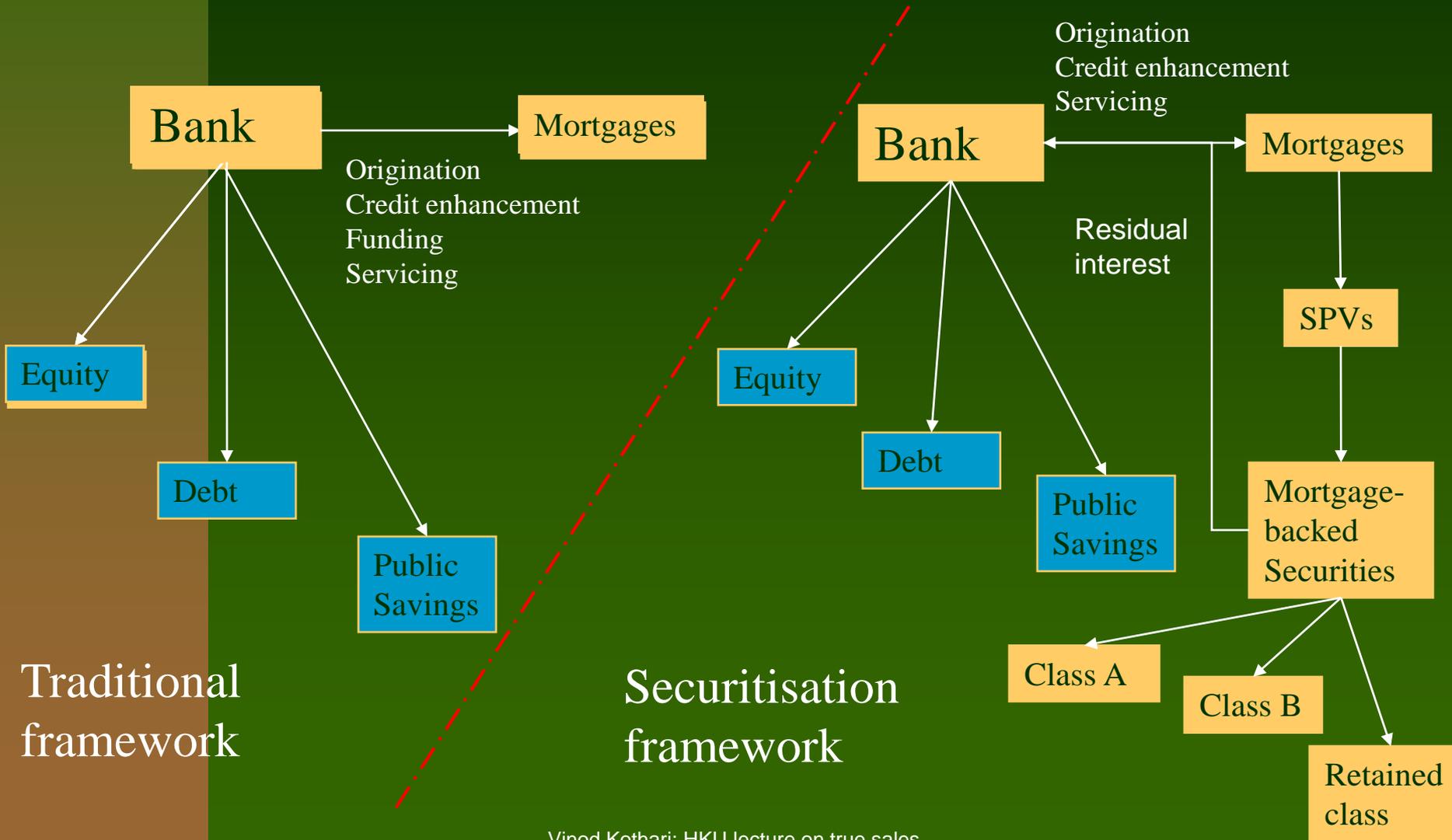
Calcutta 700 017. India

Phone 91-33-22811276/22817715/22813742/23233863/23233864

E-mail: vinod@vinodkothari.com; vinodk@vsnl.com

Fax 91-33-23233863/22811276

Essential securitisation process



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 they choose not to enforce security interests)
 - Preferential creditors
 - Claims of floating charge holders
 - Unsecured lenders
 - × A secured creditor's 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