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# Legal Risks of Conventional and Synthetic Securitisation

- A study on the common- and civil law legal conditions  
for securitisation

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# Contents

<b>SUMMARY</b>	<b>1</b>
<b>ABBREVIATIONS</b>	<b>3</b>
<b>1 INTRODUCTION</b>	<b>4</b>
1.1 Purpose	6
1.2 Method	7
1.3 Limitations	7
1.4 Disposition	8
<b>2 BANKS, RISKS AND SECURITISATION</b>	<b>9</b>
2.1 Banks and Regulatory Capital	9
2.2 Risk Management	10
<b>3 CONVENTIONAL SECURITISATION</b>	<b>13</b>
3.1 Structure	13
3.2 Illustration of the Conventional Structure	15
<b>4 SYNTHETIC SECURITISATION</b>	<b>17</b>
4.1 Structure	17
4.2 Illustration of Synthetic Structures	20
<b>5 LEGAL ISSUES- CONVENTIONAL SECURITISATION</b>	<b>23</b>
5.1 True Sale	23
5.1.1 <i>Perfection</i>	24
5.1.2 <i>Risk of reclassification</i>	25
5.2 A Clean Break	28
5.2.1 <i>Regulations and Guidelines</i>	29
5.3 Trustee management	30
5.3.1 <i>Concept of Trusts</i>	30
5.3.2 <i>Governance of the Trust</i>	32
5.3.3 <i>The importance of Trusts in Securitisation</i>	34
5.3.4 <i>Trusts in Civil Law Countries</i>	34
5.4 SPV regulations	36
5.4.1 <i>Regulations for establishment</i>	36
5.4.2 <i>License requirements</i>	36
5.5 Bankers Duty of Confidentiality	38

5.6	Civil law Securitisation Acts	38
<b>6</b>	<b>LEGAL ISSUES – SYNTHETIC SECURITISATION</b>	<b>40</b>
6.1	Credit Events	40
6.2	Enforceability	43
6.3	Confidentiality	44
6.4	Insurance	45
6.5	Imapct of Basel II	47
<b>7</b>	<b>COMPARATIVE ANALYSIS</b>	<b>49</b>
7.1	Advantages and Disadvantages	49
7.1.1	<i>The Underlying Asset</i>	49
7.1.2	<i>Governance</i>	50
7.1.3	<i>Regulatory Foundation</i>	52
7.1.4	<i>Customer Relations</i>	53
7.1.5	<i>Documentation</i>	54
7.2	Economic Considerations	55
7.2.1	<i>Securitisation as a Source of Funding</i>	55
7.2.2	<i>Balance sheet- and Capital Ratio Characteristics</i>	56
7.2.3	<i>Regulatory Capital Relief</i>	56
7.2.4	<i>Costs</i>	57
7.3	Legal Conditions for Securitisation in Civil- and Common Law Jurisdictions	58
7.3.1	<i>Conventional Securitisation</i>	58
7.3.2	<i>Synthetic Securitisation</i>	61
7.4	Synthetic Securitisation - the Better Alternative for Europe	62
<b>8</b>	<b>CONCLUSION</b>	<b>64</b>
	<b>BIBLIOGRAPHY</b>	<b>66</b>
	<b>TABLE OF CASES</b>	<b>73</b>

# Summary

Since the accomplishment of the first conventional securitisation transaction in the beginning of the 1980's, both conventional- and synthetic securitisation have played an important role in corporate finance and risk management. Banks and corporations have used these advanced financial instruments to, for example, obtain new funding for big investments, improve balance sheet characteristics and capital ratios and achieve a healthy risk management. But the mere complexity of the different arrangements and transactions involved in these financial structures, combined with the lack of established standards and usages, make both the conventional- and synthetic securitisation vulnerable to individual legal risks and uncertainties. Legal risks are dangerous to the development of a healthy securitisation market, as they may obstruct initiators and investors from participating in an otherwise profitable securitisation procedure. Legislators must therefore try to keep legal impediments to a minimum, so that the creative forces of the capital market are not held up by legal uncertainties.

Although the conventional- and synthetic securitisation have similar structures, and are often deployed to achieve the same results, they do not share the same legal risks. When a bank arranges a securitisation, the primary goal is to get rid of the risk of borrowers defaulting of their loan payments to the bank. By removing this risk, the bank is able to free up more capital that can be used for new lending, as the risk of borrowers defaulting no longer affect the bank's risk calculations of future possible liabilities. Securitisation then works as a kind of insurance for the bank: if the borrower fails to perform on his payments to the bank, a third party will take the loss. Conventional securitisation is based on the idea of legally transferring a number of specific assets, and all risks associated with them, from the initiator and his balance sheet. Naturally, a majority of all the legal risks associated with this procedure will have its origin in the establishment of a legal separation and an actual true sale of the assets. Synthetic securitisation is not based on the actual transfer of the specific assets, but rather on contractual agreements between different parties that transfer some of the economic interests of the assets through so-called credit derivatives. The legal risks of synthetic securitisation will therefore not have their origin in the establishment of a legal separation of the assets, but are more dependent on the contractual drafting and the definitions of the credit derivatives.

With the different legal risks of conventional- and synthetic securitisation in mind, it is possible to distinguish a connection between the haltering development of the continental European securitisation market and the legal foundation offered in civil law jurisdictions. Both the conventional- and synthetic securitisations are products of the American capital market. Consequently, these financial structures have been developed to fit the laws

and practices offered in common law jurisdictions. When simply implementing the Anglo-American securitisation model into the civil law legal system, legal uncertainties are bound to arise. However, as the conventional securitisation, more than the synthetic structure, is dependent on common law concepts and legal instruments, unknown to several civil law jurisdictions, the more flexible characteristics of the synthetic structure work to its advantage. The universal principle of freedom of contracts liberates the parties of the synthetic securitisation from legal risks created by jurisdictional differences, whilst the parties of the conventional securitisation are more obstructed by statutory laws in their development. Although the synthetic securitisation is troubled by several legal risks and uncertainties, these are not connected with the civil law legal framework, and the civil law initiator of a synthetic structure can therefore compete on the same terms as the rest of the world.

# Abbreviations

ABS	Asset-Backed Security
BGB	Bürgerliches Gesetzbuch
BW	Burgerlijk Wetboek
D.s.	Ministerial Publication (Sw.:Departementserien)
FAS	Financial Accounting Standards, published by the American Financial Accounting Standards Board
FFFS	Publication from the Financial Services Authority (Sw.: Finansinspektionens författningssamling)
FSA	Financial Services Authority
IAS	International Accounting Standards
ISDA	International Swaps- and Derivatives Association
NJA	Publication of Swedish Supreme Court Cases (Sw.: Nytt Juridiskt Arkiv)
OECD	Organization for Economic Co- operation and Development
UCC Prop.	Uniform Commercial Code Preparatory work from the Swedish Government (Sw.: Proposition)
S.D.N.Y	Southern District of New York (State)
SFS	Publication of Swedish Statutes (Sw.: Svensk Författningssamling)
SPV	Special Purpose Vehicle
QC	Queen's Counsel

# 1 Introduction

*“Just as the electronics industry was formed when the vacuum tubes were replaced by transistors, and transistors were then replaced by integrated circuits, the financial services industry is being transformed now that securitised credit is beginning to replace traditional lending. Like other technological transformations, this one will take place over the years, not overnight. We estimate it will take 10 to 15 years for structured securitised credit to replace completely the classical lending system – not a long time, considering that the fundamentals of banking have remained essentially unchanged since the Middle Ages.”*

These were the words of Lowell L. Bryan, Director of McKinsey and Company Inc., when asked to describe the importance of securitisation in the modern finance world.<sup>1</sup> Even though the passion and the strong belief in the future of securitisation is not shared by all parties involved with corporate finance, it is hard not to acknowledge the wide spread of securitisation transactions and its importance in the financial community. Securitisation started as an alternative way for banks and corporations to raise funds and manage risks. By selling a pool of future profits to the capital market, the initiators of a securitisation can by-pass banks and other traditional financing parties, and raise funds and transfer risks associated with certain assets in a more efficient way than previously possible. The procedure owes its popularity to the efficient technique in which it allows the parties to use a pool of assets, which are separately not suitable to sell to the capital market, as alternative collateral when raising funds.

Conventional securitisation<sup>2</sup> started in the beginning of 1980, when U.S. commercial banks initiated the transfer of mortgages to the capital market by this new financial procedure. By doing so, they could both raise funds for future projects as well as getting rid of the risks associated with the loans. Since then, the market of securitisation, as well as the range of different assets that can be securitised, have grown rapidly and royalties of artists, rights over perfumes, future revenues of films and records, credit card receivables, student loans, lottery winnings and even future incomes of government taxes are only a few examples of assets that have been securitised.<sup>3</sup> The mortgage- and the asset-backed securitisation is today an industry comprising over 2.7 trillion US\$ in the US alone<sup>4</sup> and is increasing in Europe, Latin America and Japan.<sup>5</sup>

The mere structure of the securitisation has however caused some legal problems, especially in jurisdictions with a legal system other than the

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<sup>1</sup> Kothari, Vinod, *Securitisation- a Primer*

<sup>2</sup> Conventional securitisation can also be referred to as Traditional securitisation or True-Sale securitisation

<sup>3</sup> Leixner, Timothy C., *Securitization of Financial Assets*, page 1

<sup>4</sup> Lastra, Rosa Maria, *Risk-based capital requirements and their impact upon the banking industry*

<sup>5</sup> Leixner, Timothy C., *Securitization of Financial Assets*

common law. The structure of securitisation is complex both because of the amount of transactions required and the legal nature and quantity of parties involved. Furthermore, being invented and primarily developed inside the U.S. and the U.K., the securitisation structure requires the use of some of the important legal structures and instruments that are exclusive for these jurisdictions, to be fully effective. For example, the important role of trusts in the securitisation structure is a problem in civil law countries, as the concept of trust generally does not exist in these jurisdictions. In addition, problems such as difficulties for trustees trying to enforce the collection of the receivables, additional tax burdens and unpredictable court decisions often arise due to the lack of harmonized markets and regulations in Europe.<sup>6</sup>

For a long time, European securitisation initiators had no other choice than to arrange their securitisation structures in offshore securitisation friendly-, common law jurisdictions, due to the lacking legal- and economic framework in civil law jurisdictions. However, this practice put the participants of civil law securitisations in a disadvantageous position in relation to their common law equivalents, as cross-border securitisations increase the transaction costs in terms of, for example, additional foreign legal- and accounting fees and increased currency exchange risks caused by variations in currency exchange rates. Beginning in the late 1980s, and up until now, European legislators have tried to reduce these transaction costs by promoting domestic securitisation markets. But even though some jurisdictions have adopted special Securitisation Acts, especially designed to incorporate securitisation, the effectiveness of these rules has been limited, since the legislation is often incomplete or flawed.<sup>7</sup>

Countries outside the U.S. therefore started to look at alternatives to the conventional securitisation, and the so-called Synthetic Securitisation soon grew in popularity.<sup>8</sup> The synthetic securitisation is able to synthetically reflect and reproduce several effects of the conventional securitisation through specialised bilateral agreements between the parties of the structure. The conventional securitisation necessitates a legal transfer of assets from the initiator's possession and ownership in order to be successful and through the legal transfer of the assets, the initiator gets an advanced payment on the pool of assets transferred, and all the risks associated with them are transferred to a third party. However, the synthetic securitisation imitates results achieved by conventional securitisation, but without actually transferring any assets from the initiator. Instead, the synthetic structure contractually transfers some of the economic interests and risks associated with the specific asset.

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<sup>6</sup> Leixner, Timothy C., *Securitization of Financial Assets*, page 3

<sup>7</sup> Frankel, Tamar, *Cross-Border Securitization: Without Law, But Not Lawless* and Leixner, Timothy C., *Securitization of Financial Assets*

<sup>8</sup> The TEGoVA-guide "European Mortgage Securitisation: A Valuer's Guide" published in 2002, page 1-6

The usages of synthetic securitisation grew especially popular with banks. Banks generally engage in securitisation to get rid of the risk associated with its creditors not fulfilling their payments obligations, the credit risk, and not because they need to remove the assets from the balance sheet. Due to duties of confidentiality and relations with customers, banks are not interested in the actual transfer of e.g. corporate loans, but rather search for an effective risk management that will keep the relationship between the bank and its corporate borrowers intact.<sup>9</sup> The first synthetic securitisation in Europe was structured by Citibank in June 1999 and went under the name CStar. Other banks soon followed suit, and in the end of 1999 Deutsche Bank AG closed a synthetic securitisation transaction, called CAST 1999-1.<sup>10</sup>

Through the avoidance of any real asset transfer, the synthetic securitisation is able to circumvent many of the legal issues related to the conventional structure and the separation of assets.<sup>11</sup> However, the synthetic securitisation structure suffers from negative legal complications of its own, which may jeopardise the purpose of the procedure. Problems with enforceability, indefinite contract terms and incomplete regulatory frameworks are only a few examples.

## 1.1 Purpose

A solid legal foundation is a fundamental condition for the efficiency and success of any modern financial instrument. No matter how strong the economic interests and the incentives of the market are, the ingenious and creative innovations of the capital market will always be held back by a restrictive legal system. Both conventional- and synthetic securitisations are complex financial structures that are highly dependent on the enforceability and legal recognition of the transactions and arrangements included in the procedures. With legal barriers, creating uncertainties and legal risks, securitisation will never be able to develop and show its full potential.

This paper will study both the common- and the civil law legal systems' effects on the development and efficiency of conventional- and synthetic securitisation within the banking industry. Through a comparative study of the relevant characteristics of common- and civil law, central differences between the two legal systems' treatment of the legal risks of securitisation will be highlighted and studied in detail. *Firstly*, the key legal risks of securitisation will be emphasized and examined from both an international- and a jurisdictional perspective. *Secondly*, in order to differentiate the sources of the legal risks of conventional- and synthetic securitisation, the

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<sup>9</sup> Black, Julian M., *Synthetic Securitisation: the Cayman Islands Perspective*

<sup>10</sup> Böhringer, Dr. Martin, *Conventional versus Synthetic Securitisation– Trends in the German ABS Market*, page 5

<sup>11</sup> Böhringer, Dr. Martin, *Conventional versus Synthetic Securitisation– Trends in the German ABS Market*, page 31

advantages and drawbacks of the two structures will be weighed against each other from a legal perspective. *Finally*, the legal conditions of securitisation in both common- and civil law jurisdictions will be analysed with the aim of illustrating the two different legal systems effects on the efficiency of the securitisation market.

By following these steps, this paper intend to show the consequences and connections between legal risks and the efficiency and success of securitisation structures, and how these risks can be an important aspect when explaining the different developments of common- and civil law securitisation markets.

## **1.2 Method**

By first studying the separate structures and transactions included in securitisation from a legal perspective, this paper aims to establish the primary legal risks of both conventional- and synthetic securitisation. Ones acknowledged, these legal risks will be put into a jurisdictional context in order to examine how these risks are dealt with in different jurisdictions and legal systems. Through a comparison of how different jurisdictions solves and deals with the legal risks of securitisation, this paper intend to produce a comprehensible illustration of the legal climate for securitisation in both civil- and common law legal systems.

In order to establish the legal risks of securitisation, this paper will found its research on the leading literature of International Finance Law from primarily the U.S., the U.K. and Sweden. However, since the subject of modern finance law is constantly changing and developing, there is a shortage of relevant and updated published literature, and articles and guidelines published by respected internet sources will also play an important role in the research. The comparison of legal differences between the separate countries included in this study will primarily be based on the examination of national statutory laws, regulations, case law and practices in each jurisdiction. Like any other comparative study, these legal resources will be examined in their full context with the help of relevant literature, as legal issues are dealt with differently depending on the specific jurisdiction.

## **1.3 Limitations**

As this is first and foremost a study of the legal risks associated with securitisation, economic risks of for example derivative transactions and other financial instruments included in a securitisation structure will only be briefly explained in this paper. A strictly legal comparison of the conventional- and synthetic securitisation also exclude a detailed study of the different economic results achieved by either the conventional- or the synthetic securitisation. Both conventional- and synthetic securitisation can

have a variety of different purposes and results, and the securitisation structure may thereby differ, depending on the intentions of the arranging parties. Examples, models and explanations of the transactions and structures of securitisation will therefore, if the contrary is not expressly stated, assume the scenario where a bank or financial institution engage in securitisation for the purpose of transferring credit risk from the underlying assets. Furthermore, in order to focus on the legal risks of the securitisation structure and its transactions, and not on its profitability or economic effectiveness, Tax Law will be left outside the scope of this study.

## **1.4 Disposition**

The study of the legal risks of securitisation is divided into three different parts. Part One, which include chapter 2, 3 and 4, aims to introduce the reader to the structure and rationale behind conventional- and synthetic securitisation, by explaining the structure and its transactions and the possible purposes of a securitisation initiator. Part Two, which includes chapter 5 and 6, will study in detail the most important legal risks of securitisation and how these risks are dealt with in both common- and civil law jurisdictions. Part Three, which includes chapter 7, will finally analyse the different advantages and disadvantages of the two different structures. This part will furthermore explain how these differences in legal characteristics of conventional- and synthetic securitisation are reflected in the development and success of securitisation markets in both common- and civil law jurisdictions.

Part One and Two are strictly descriptive, whilst Part Three will analyse the descriptive material and put it into context according to the purposes of this paper.

## 2 Banks, Risks and Securitisation

Within the banking industry, both conventional- and synthetic securitisation has evolved through the rising need of better asset management and limitations of credit risk exposure. This chapter will briefly show how the securitisation market has developed and further explain its popularity within the banking community.

### 2.1 Banks and Regulatory Capital

A bank makes its profits from the difference between what it is required to pay to e.g. its depositors, lenders and shareholders, and what it receives from its borrowers. A disturbance in this simple equation occurs when borrowers default, and are incapable of paying back their debts, as it is the bank, and not its depositors, which assumes this Credit Risk. In order for the bank to avoid having to apply for bankruptcy as soon as borrower default occurs, the bank has to set aside a cash reserve, Regulatory Capital, consisting of share capital and held back profits. Regulatory authorities all over the world regulate this procedure in order to ensure that the shareholders, lenders and other stakeholders of the bank will receive some payment, should insolvency occur.<sup>12</sup>

Through sometimes highly complicated calculations these regulations require banks to categorise assets according to their degree of risk and to allocate a specific amount of capital to each category. The main authority on this area is the Basel Committee, a committee established by the central bank governors of the Group of Ten countries. Their work on regulations for banks and credit institutions has framed the foundation for numerous of laws all over the world, as well as for EC directives.<sup>13</sup> For example, the Swedish Regulatory Capital Act<sup>14</sup> is based on Basel I, regulations published by the Basel Committee. Basel I, and Basel II which will come into effect in the beginning of 2007, are capital adequacy frameworks that handle market disciplines to promote stability in the financial system, supervisory banking guidelines and minimum capital requirements. These regulations constitute that a minimum level of capital of 8 % of the weighted risk assets should be held at all times.<sup>15</sup> Furthermore, the regulations divide the assets into different risk categories, which are classified depending on the weighted risk of the counterparty. An OECD member state has for example a

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<sup>12</sup> Bell, Dawson, *Synthetic Securitisation: Use of Derivative Technology for Credit Transfer*

<sup>13</sup> *Riskmätning och kapitalkrav*, Report nr 2001:1 from the Swedish Financial Services Authority (Sv.:Finansinspektionen), page 2

<sup>14</sup> Lag (1994:2004) om kapitaltäckningar och stora exponeringar för kreditinstitut och värdepappersbolag

<sup>15</sup> Norton, Joseph J., *Bank Regulations and Supervision in the 1990s*, page 92-93

weighted risk of 0 %, whilst an OECD member state bank has a weighted risk of 20 %. Residential mortgages fully secured by residential property have a weighted risk of 50% and virtually all other assets and liabilities are taken up to 100 %. The implementation of the new Basel II will to a certain degree affect and change the methods of calculating weighted risk and certain more sophisticated banks will furthermore be able to use their own risk assessments in calculating their capital requirements.<sup>16</sup> The basic principles of a required capital reserve for banks and credit institutions will however remain, and banks will still be required to hold 8% of the weighted risk assets in regulatory capital.<sup>17</sup>

## 2.2 Risk Management

Through the regulatory capital requirements, regulators have been able to establish structure and stability to the solvency issues of the banking industry. Banks have however tried to avoid these requirements as there is an economic cost associated with merely holding on to capital, and the more capital a bank is required to hold, the more expensive the cost of lending tends to be. This simple fact has given birth to the idea of asset transfer among banks and the receivables securitisation market. Through securitisation, banks are able to pool together a number of loans and receivables and transfer them to the capital market, without recourse to the banks. As the assets are taken off the banks' balance sheet, the credit risk is absorbed by the capital market, and the banks do not need to reserve any capital for these securitised assets.<sup>18</sup>

Credit risks are however not the only kind of risks associated with lending. In the wide variety of businesses and transactions of banks and credit institutions, different types of risks can be identified. There are numerous variations of classifications of different risks, but some of the most important risk categories of the banking industry are credit-, market-, operational- and legal risks.<sup>19</sup> *Market risk*, or *Systemic risk*, is usually defined as the possibility that downward market trends will reduce the market value of an investment. Interest rates, fluctuations in stock prices and currency exchange rates are important factors that influence the market risk.<sup>20</sup> *Operational risk* is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external

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<sup>16</sup> The research paper “*Basel II and Banks: Key aspects and likely market impacts*” from Nomura Securities International

<sup>17</sup> *Riskmätning och kapitalkrav*, Report nr 2001:1 from the Swedish Financial Services Authority (Sv.:Finansinspektionen), page 5-6

<sup>18</sup> Bell, Ian, *Synthetic Securitisation: Use of Derivative Technology for Credit Transfer*

<sup>19</sup> SOU 1998:160, page 193-195

<sup>20</sup> *Managing Market Risks (Sv.: Hantering av markandsrisker)*, Report published by the Swedish Central Bank, page 1

events.<sup>21</sup> *Legal risk* arises through uncertainty in laws, regulations and legal actions. Capacity and enforceability issues, the legality and classification of financial instruments and the exposure to unanticipated changes in laws and regulations all contribute to create legal risk.<sup>22</sup>

Banks generally try to limit and hedge themselves from these risks through different kinds of risk management procedures. As *Operational risks* have their origin in the internal process of the bank, the best way to hedge from these risks is to establish an effective internal organisation. *Legal risks* are inevitably dependent on the judgement of third party regulators and judiciaries, but can, to some extent, be limited through prudent and well-drafted documentation, as well as through an established knowledge of the relevant legal system. *Market risks*, however, are completely independent of the businesses of the bank as they are the result of trends in the market that are out of the bank's control. In order to limit and hedge themselves from these risks, banks have usually turned their heads to the derivatives market. Derivative contracts are securities where the price is dependent on or derived from underlying assets, and their value is determined by fluctuations in these assets. For example, the risk of currency fluctuations, Currency Risks, may be transferred through a derivative called a Currency Swap. When liabilities of a bank are not denominated in the same currency as their assets, the risk that the asset currency is devaluated in relation to the liability currency arises. A bilateral Currency Swap with another party enables the bank to exchange the principal and interest in one currency for the same in another, eliminating the risk of currency fluctuations. Another example is the Interest Rate Swap that is used to manage the exposure to fluctuations in interest rates. If, for example, one party is tied up by a long-term fixed interest rate, he may exchange a stream of future interest payments based on a specified principal amount for another stream that is set up as a floating interest rate.

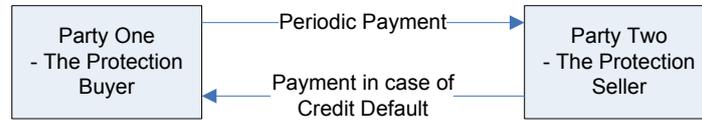
The same principle, to derive the value and price of a security from another underlying asset by using derivatives, can also be used to transfer credit risk. With a Credit Derivative, a bank can transfer the risk of an obligation default to another party, and thereby reduce the regulatory capital reserve needed to ensure its solvency and payment obligations. For example, the most basic Credit Derivative, the Credit default Swap, works much like an insurance contract. In return for a periodic fee from Party One, Party Two of the bilateral contract promises to pay an amount equal to the loss suffered by Party One from creditors who default their payments. This way Party One will be indemnified from losses associated with its obligors' credit defaults, and the credit risk of borrower defaults is replaced by the often lower risk of the swap counterparty defaulting on his protection payment obligation.

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<sup>21</sup> *Operational Risks (Sv.: Operativa risker)*, From the report "Finansiell stabilitet 2/2002" published by the Swedish Central Bank, page 50

<sup>22</sup> Georgsson, Magnus, *Kontroll av legala risker i förvaltningen av finansiella tillgångar*, From the report "Penning- och valutapolitik 1/2006" published by the Swedish Central Bank, page 24-26

Schedule 1: The Credit  
Default Swap



Source: *The J.P. Morgan Guide to Credit Derivatives*

The synthetic securitisation combines the advantages of credit derivatives and conventional securitisation, and offers the bank an efficient alternative to the conventional securitisation when transferring credit risks and avoiding capital requirements. Using a structure very similar to the conventional securitisation, the synthetic alternative uses a number of credit derivatives in order to transfer the credit risk of the initiator to the capital market. The synthetic securitisation thereby replicates the economic risk transfer characteristics of the conventional securitisation, without changing the appearance of the initiators balance sheet or transferring any assets. As the assets remain on the initiator's balance sheet, the amount of credit risk that can be transferred to third parties through synthetic securitisation is highly dependent on the structuring of the procedure, the drafting of the credit derivatives and on other engagements and commitments made by the parties of the synthetic structure.<sup>23</sup> Depending on the choice of the many variations of synthetic securitisation arrangements, the procedure can however be just as efficient as the conventional structure when obtaining regulatory capital relief and transferring credit risk.<sup>24</sup>

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<sup>23</sup> *Basel Committee on Banking Supervision: A consultative document on Asset Securitisation*, page 20-21

<sup>24</sup> The efficiency and capability to transfer credit risk of the synthetic securitisation will be further explained in Section 4.1

# 3 Conventional Securitisation

Securitisation is the process of creating a financial instrument by transforming categories of assets and securities into new forms and then marketing them to investors. By using the superior knowledge of the expected financial behaviour concerning a particular asset, as opposed to the knowledge of the transferor's expected financial behaviour, a number of advantageous results can be achieved for all parties involved.<sup>25</sup> Securitisation can for instance be used to free up cash by selling illiquid assets to an entity separated from the transferor's organisation.<sup>26</sup> It can also be used to reduce the cost of funding since the overall capital costs must not take into account all the collective risks and uncertainties associated with the transferor's business operations, but only the risks of the assets themselves.<sup>27</sup> Furthermore, securitisation offers banks, financial institutions, corporations etc, an efficient tool to manage regulatory capital and balance sheet- characteristics, to improve capital- and leverage ratios<sup>28</sup> and to achieve a healthy risk management.<sup>29</sup>

The structure of securitisation can take many forms and use a variation of financial instruments to achieve the relevant results. Furthermore, the structure varies depending on the legal framework in the relevant jurisdiction as different jurisdictions allow for different solutions. However, the basic principles behind every structure, as well as the parties involved, are often the same, even if titles and specific transactions may vary. This chapter will explain the basic principles and arrangements of the standard Anglo-American securitisation structure.

## 3.1 Structure

In a typical securitisation structure a bank, a financial institution or a company (the **Originator**) transfers a large pool of receivables, which are created in the Originator's course of business and which generate a steady income, to a bankruptcy remote Special Purpose Vehicle (**SPV**).<sup>30</sup> The SPV, structured as a corporation, limited liability company or a trust depending on the relevant jurisdiction, has the sole purpose of owning the assets<sup>31</sup>. The

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<sup>25</sup> Schwarcz, Steven L., *Securitization Post Enron*, page 1541

<sup>26</sup> prop. 2000/01:19, *Better conditions for Securitisation (Sw.:Bättre förutsättningar för värdepapperisering)*, page 11

<sup>27</sup> Telpner, Joel, *A securitisation primer for first time users*

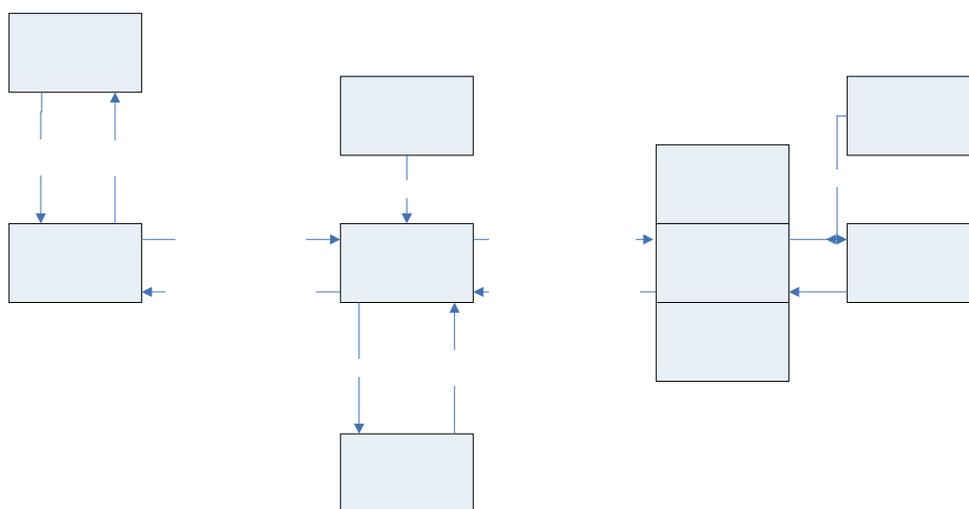
<sup>28</sup> *Ratios* are used as indicators of the financial status of a bank or corporation when examining the financial aspects of its business. *Leverage ratios* can for example be used to indicate what proportion of debt a company or bank has to its assets by dividing the total debt with the total assets. Similarly, *capital ratios* are used to measure what proportion of capital a company or bank has to its assets. (Source: Bloomberg Financial Glossary, [www.bloomberg.com](http://www.bloomberg.com))

<sup>29</sup> Kravitt, Jason, *Introduction to Securitization*

<sup>30</sup> Karlsson, Robert, *Cross-border securitization from a Swedish Perspective*

<sup>31</sup> Månsson, Fredrik, *Värdepapperisering*, page 15

SPV is bankruptcy remote in relation to the Originator and to its investors, and therefore has an asset/liability structure and a legal status that make its obligations secure even if the Originator, or the investors, go bankrupt.<sup>32</sup> In exchange for the transfer of assets, the Originator receives an amount in cash from the SPV. This acquisition of assets is funded by the issuing of asset-backed notes by the SPV (the **Issuer**) to investors, either in a private placement or through a public offering. These notes are secured in the receivables and subsequently satisfied from their proceeds.<sup>33</sup> Usually these asset-backed notes are divided into different classes and further subdivided into different tranches with different risks, terms and conditions. The three most common classes in a securitisation structure are often called the senior, the mezzanine and the junior class, and the risk is allocated from the junior class to the senior class. Hence, the junior class investors bear the biggest risk, since in a case of a credit default by one of the assets in the SPV, the junior class will be the first to suffer the loss. In return, the junior class has the highest rate of return, and typical investors in this class are therefore hedge funds and private investors. Consequently, the senior class is the safest class, but also the class with the lowest rate of return with pension funds and insurance companies as typical investors. The different classes of asset-backed notes are rated by rating agencies and it is common to use some sort of credit enhancement in order to achieve a high credit rating. Such credit enhancement can consist of over-collateralisation, guarantees from insurance companies and highly rated banks, letters of credits, different varieties of swap agreements etc.<sup>34</sup>



Source: *Conventional versus Synthetic Securitisation*<sup>35</sup>

<sup>32</sup> *European Mortgage Securitisation: A valuer's guide*, The European group of valuer's Associations, page 4

<sup>33</sup> Leixner, Timothy C., *Securitization of Financial Assets*

<sup>34</sup> *The International Comparative Legal Guide to: Securitisation 2005*, Global Legal Group, page 4

<sup>35</sup> Böhringer, Dr. Martin, *Conventional versus Synthetic Securitisation– Trends in the German ABS Market*

It is customary for the Originator to keep some of the administrative obligations of the underlying assets in the SPV since he often has the best knowledge and capacity to, for example, process collections. Although not common, these duties can also be delegated by the SPV to other institutions or individuals.<sup>36</sup> The securitisation structure often divides the administrative responsibilities into two categories: the routine asset portfolio administration, such as making and processing collections, temporary reinvesting asset proceeds is managed by the **Servicer**, while the active management and trading of the underlying asset pool is managed by the **Administrator**.<sup>37</sup> Another key player in the securitisation structure is the **Trustee**. The trustee's main obligations are to hold and separate the securitisation cash flows in segregated accounts, to hold the Issuer's assets granted as security for the Issuer's obligations and to provide investors and rating agencies with information of existing events of defaults and covenant breaches.<sup>38</sup>

## 3.2 Illustration of the Conventional Structure

This part will demonstrate how two real securitisation structures have been previously arranged. Both examples, Deutsche Bank's structure called *CORE 1999-1*<sup>39</sup> and the Swedish SBAB's conventional securitisation called *SRM Investment No 3*<sup>40</sup> will be illustrated through simplified explanations of the arrangements and transactions made in each procedure.

*CORE 1999-1*: The Originator sells a pool of assets, consisting of corporate loans from mid-sized companies, to an SPV that is registered in Jersey. Jersey is especially suited for European securitisation structures as it has a stable economy, is in the GMT time zone and a strong legal framework that promotes securitisation.<sup>41</sup> In this case, the SPV is formed as a trust in order to ensure the independent ownership of the assets, with no legal governance relations to the Originator, but other independent legal entities might also be suitable as SPVs. To fund the true sale of the assets, the SPV issues asset-backed notes consisting of three different classes, which are further subdivided into 12 different tranches. The different classes and tranches of the notes are rated by rating agencies, and offer different interest rates depending on their separate risks. The lowest tranche carries the highest risk, and the risks are allocated from the bottom to the top class. Due to the strong tradition of a financial orientated trust law in the U.S., and in order to

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<sup>36</sup> Böhlinger, Dr. Martin, *Conventional versus Synthetic Securitisation– Trends in the German ABS Market*, page 10-11

<sup>37</sup> Telpner, Joel, *A securitisation primer for first time issuers*, page 4

<sup>38</sup> Ibid.

<sup>39</sup> See Böhlinger, Dr. Martin, *Conventional versus Synthetic Securitisation– Trends in the German ABS Market*, page 37 ff

<sup>40</sup> See <http://www.sbab.se/sbab/jsp/polopoly.jsp?d=157&a=1931>, 2006-10-20

<sup>41</sup> Hollywood, Shane, *Securitisation and SPVs in Jersey*

simplify the issuing of notes on the U.S. capital market, an American bank is furthermore selected as the trustee acting on the behalf of the investors.

In order to hedge itself from different kinds of market risks, the SPV enters into several swap contracts, such as interest rate- and currency swaps, with third parties. This structure also uses a variety of credit enhancements in order to achieve a high credit rating on the issued notes and to avoid shortfalls in interest payments. In relation to the senior notes, the actual division of the notes into different classes and tranches works as a credit enhancement in itself, as the first loss is taken up by the junior notes. Furthermore, a reserve fund is arranged to act as a buffer for delayed interest payments and realised losses.

Common for a conventional securitisation, this structure is fully funded. This means that the value of the reference pool is equal to the value of the issued notes.

*SRM Investment No 3:* The Originator, a Swedish real estate financing institution, transfers a pool of receivables to a corporate SPV, owned by a trust, and registered in Jersey. A trustee, Law Debenture Trust, is furthermore appointed to represent the investors. The SPV finance the true sale of the assets with the funds received from an issue of asset-backed notes to investors in the Swedish-, but also the American and British market. The purchase of the underlying assets is fully funded, and the value of the issued asset-backed notes is equal to the value of the assets received. The asset-backed notes are divided into 4 different tranches, and the most senior tranche, constituting almost 90% of all notes issued, gets the highest possible rating, i.e. AAA/Aaa, from the rating institutions Standard & Poor's and Moody's. SBAB continues to act as the servicer for the assets transferred, and thereby keeps some of its administrative responsibilities.

## 4 Synthetic Securitisation

As mentioned above, the purpose of a conventional securitisation may be to remove assets from the originators balance sheet, to obtain capital- or other regulatory relief or to get financing at a price otherwise unavailable to the Originator. The Synthetic securitisation can achieve some of these economic results, but without actually transferring the assets from the Originator. Where the conventional securitisation focuses on separating the assets, along with their credit risk, the synthetic securitisation separates and transfers the credit risk of the assets without removing them from the balance sheet. By combining both the advantages of conventional securitisation and credit derivatives, banks and other potential initiators transfer the credit risk of a pool of assets by using credit derivatives such as swaps and credit-linked notes. The credit risk is thereby transferred to a party separated from the transferor, who in case of creditor defaults in relation to the specified assets, will have to pay the loss that would otherwise belong to the transferor. Similar to an insurance contract, the synthetic securitisation protects the transferor from unpredictable events related to the solvency of his creditors, relieving him from the credit risk of the assets. This type of risk management can be a very important tool for banks to free up regulatory capital, which they by law<sup>42</sup> have to set aside against each loan.<sup>43</sup>

### 4.1 Structure

There are two main parties in the synthetic securitisation, the **Protection Buyer** and the **Protection Seller**. The Protection Buyer, who is generally the owner of a portfolio of assets, the **Reference Portfolio**, transfers the credit risk of the Reference Portfolio either to a Protection Seller-SPV or directly to the open market, but the actual ownership of the portfolio remains with the Protection Buyer. The credit risk transferred can consist of the credit risk either of a company, the **Reference Entity**, or of one or a variety of assets, the **Reference Obligations**, such as corporate loans, corporate bonds, guarantees, letters of credit etc. The transfer of credit risk can be made in a number of ways, but the most common credit risk transfers in synthetic securitisation are made through the issuing of credit derivatives such as credit-linked notes and credit default swaps.<sup>44</sup>

*Credit-linked notes* can be compared with a standard term loan to the Protection Buyer from the investors, with a pre-determined interest rate paid periodically to the investors. However, under the Protection Buyer's

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<sup>42</sup> See Section 2.1

<sup>43</sup> Uwaifo, Elizabeth and Greenberg, Mark, *Europe Securitisation and Structured Finance Guide 2001*, page 1-2

<sup>44</sup> Uwaifo, Elizabeth and Greenberg, Mark, *Europe Securitisation and Structured Finance Guide 2001*, page 2

repayment obligation of the notes is a term that provides for a reduction of the repayment sum, in case of credit default or other credit events arising from the Reference Portfolio. In return for a periodic interest rate, the investors of a credit-linked note therefore accept the risk of a reduced repayment on their loan to the Protection Buyer in case of any credit defaults. The price of the note is linked to the performance of the reference asset in the Reference Portfolio, and the investors get a higher yield on the note in exchange of accepting the risk of a possible credit event. The credit-linked note can be issued either directly to investors or to a Protection Seller SPV, and the purchase price is often delivered to the Protection Buyer on the issuing date.<sup>45</sup>

*Credit default swaps* are credit derivatives were the Protection Buyer enters into a bilateral agreement with the Protection Seller who accept the credit risk of the Reference Portfolio. In an ordinary credit default swap the Protection Seller, often a highly rated bank, agrees to make a payment to the Protection Buyer upon the occurrence of a credit event in relation to the Reference Obligation or the Reference Entity. In return, the Protection Seller receives regular payments from the Protection Buyer. In case of default or a credit event in respect of a Reference Obligation or a Reference Entity, and if certain conditions are satisfied, the Protection Seller will pay an amount to the Protection Buyer, calculated by reference either to the amount of payment defaults or the decrease of the market value of the defaulted Reference Obligation.<sup>46</sup> Common defaults that could trigger such a payment are bankruptcy, failure to pay, obligation default, obligation acceleration, restructuring, repudiation etc<sup>47</sup>, but any events of default agreed by the parties for the individual transaction can be included.<sup>48</sup> Furthermore, to constitute a default, it must often exceed a materiality threshold that is predetermined. The definition of a credit event is in itself very important for investors, as the broader the definition, the broader the risk.<sup>49</sup>

The typical synthetic securitisation structure often combines the issuing of credit-linked notes with the credit default swap. Credit-linked notes, which usually comprise 10-15% of the credit risk transferred, traditionally take the first loss in the event of any credit default. Similar to the conventional securitisation, the credit-linked notes are furthermore divided into different classes and tranches, with different risks and rates of return. The risk of suffering loss in case of a credit event is allocated from the junior class note holders to the senior classes, comparable with the risk allocation of asset-backed notes in the conventional securitisation. The safest of all the Protection Sellers in the synthetic securitisation structure is consequently the

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<sup>45</sup> *The J.P. Morgan Guide to Credit Derivatives*, page 24-28

<sup>46</sup> Uwaifo, Elizabeth, *Europe Securitisation and Structured Finance Guide 2001*, page 2

<sup>47</sup> See the “2003 ISDA Credit Derivatives Definitions”. For a comprehensive explanation of the ISDA definitions, see Section 6.1

<sup>48</sup> *Credit default swaps – functions, importance and information content*, Deutsche Bundesbank’s Monthly Report, December 2004

<sup>49</sup> *The J.P. Morgan Guide to Credit Derivatives*, page 12

credit default swap counterparty, who normally answers for 85-90% of the credit risk transferred. The credit default swap counterparty can be described as a super senior class Protection Seller with a minimum risk of suffering loss, who receives a relatively small periodic premium for his credit protection services. The mere structure of the synthetic securitisation, with credit-linked note holders taking the first loss in case of any credit events, functions as an efficient credit enhancement in favour of the super senior swap counterparty. As the swap counterparty's risk of suffering loss is very low, the Protection Buyer can thereby transfer the majority of the credit risk for a relatively cheap price.<sup>50</sup>

The parties in a synthetic securitisation can choose to make a funded, partly funded or an unfunded structure. In the *funded structure*, the Protection Seller's payment obligation is discharged in full in the beginning of the transaction. The credit-linked notes in a synthetic securitisation are considered funded through the Protection Seller's cash settled purchase of the notes, issued directly by the Protection Buyer or through an intermediary SPV. A credit default swap in a synthetic securitisation is considered funded by the Protection Seller's presentation of collateral, to secure the Protection Seller's obligation under the credit default swap. The funded structure is a good choice when for example a bank wants to reduce regulatory capital costs. If the Protection Seller's payment obligation is collateralised with cash or other collateral equivalent to cash, the credit derivatives will be treated as cash collateralized transactions and a risk weighting<sup>51</sup> for the Reference Obligation of 0% can thereby be achieved. In a *partly funded* synthetic securitisation, only certain parts of the credit risk in respect of the Reference Obligation are funded. For example, the Protection Buyer can choose to issue funded credit linked notes in combination with an unfunded credit default swap, with no collateral to secure the Protection Seller's payment obligation. In an *unfunded structure*, the investors do not transfer any money to the Protection Buyer in advance, but merely stand ready to pay the Protection Amount if the pre-agreed credit events occur. This means that without any kind of credit enhancement involved, the risk weighting of the Reference Obligation will be replaced by the risk of the obligations issued by the Protection Seller. For example, if the Protection Seller is an OECD member state bank, and the Reference Obligation consists of corporate bonds, the risk weighting can be reduced from a 100% to 20%. Although the funded structure seems to be the best solution, one must have in mind that it is often the most expensive one. The profitability depends on the size of the Reference Portfolio, as the cost of maintaining the funding, in respect of the entire portfolio, may be unreasonably high.<sup>52</sup>

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<sup>50</sup> Böhlinger, Dr. Martin, *Conventional versus Synthetic Securitisation– Trends in the German ABS Market*, page 26-30

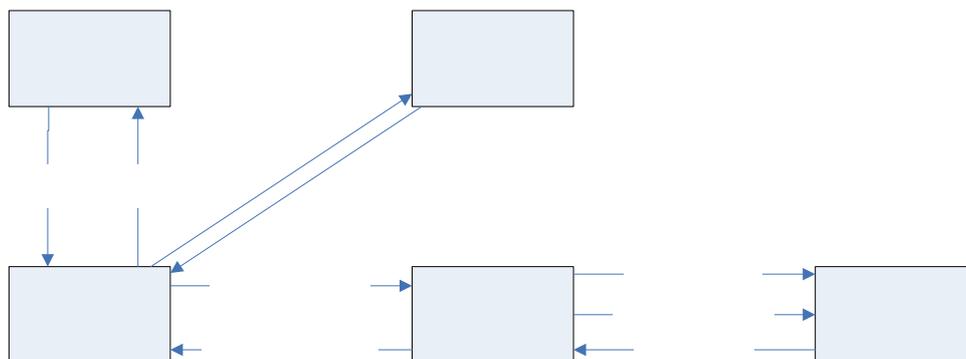
<sup>51</sup> *Basel Committee on Banking Supervision: International Convergence of Capital Measurement and Capital Standards 2004*, page 30-32

<sup>52</sup> The Committee on the Global Financial System's report *Credit risk transfer* of 2003, page 30-42

The Protection Buyer can choose either to transfer the credit risk of the Reference Portfolio directly to the Protection Seller or to an SPV. In an *SPV structure*, the credit-linked notes, or the credit default swap, are issued by, or entered with, the SPV, which undertakes to pay a credit protection amount in the event of a credit default. The credit protection amount is funded with proceeds, often held by a trustee, of the issue of notes to investors with different classes of expected returns and risks. In a synthetic securitisation structure that does *not use an SPV*, the Protection Buyer issues credit-linked notes or enters into a credit default swap directly with the investors. The advantages of using an SPV structure are that the notes issued by the SPV can be rated independently from the rating of the Protection Buyer and these notes can therefore be rated higher than the Protection Buyer's debt rating. On the other hand, the structure not using an SPV eliminates the often extensive cost of setting up and administering the SPV.<sup>53</sup>

## 4.2 Illustration of Synthetic Structures

In order to illustrate how the synthetic securitisation can be structured, this part will give a more detailed explanation of two individual synthetic securitisations. The first example is based on a synthetic structure formerly set up by Rabobank, and the second example on a structure arranged by Deutsche Bank.



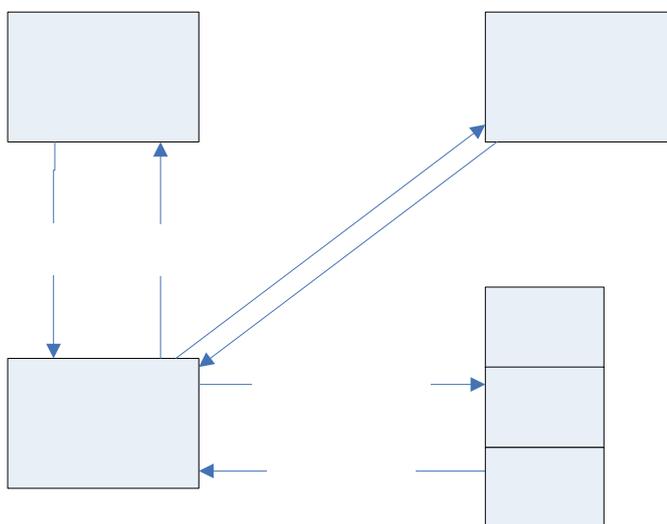
Source: *The J.P. Morgan Guide to Credit Derivatives*

*Example of a synthetic securitisation consisting of a funded and an unfunded portion using an SPV structure*<sup>54</sup>. In the funded part of the structure, the Protection Buyer enters into a credit default swap with a bankruptcy remote SPV, which agrees, that in return for payment from the

<sup>53</sup> Böhringer, Dr. Martin, *Conventional versus Synthetic Securitisation– Trends in the German ABS Market*, page 26-31

<sup>54</sup> This example is based on the synthetic securitisation arranged by Rabobank International in 2000 through Sundial Finance Limited with a 2 500 000 000 Euro portfolio.

Protection Buyer of a swap premium, the SPV will pay the Protection Amount in case of a credit event in respect of the reference obligation. The credit events are specified and consist of bankruptcy or failure to pay. However, the SPV is not liable to pay the Credit Protection Amount until the losses of the Reference Portfolio exceed a first initial sum<sup>55</sup>. The credit Protection Amount is funded by the proceeds of the SPV's issue of floating rate notes consisting of Class A, Class B, Class C and Class D notes. The proceeds of the issue are invested in highly liquid OECD government bonds, under a repurchase agreement with the Protection Buyer as a repurchase (Repo) Counterparty. If the SPV is required to make a credit protection payment to the Protection Buyer, the Protection Buyer will then, as a Repo Counterparty, be required to repurchase equivalent government bonds, having a market value equal to the amount of such payment. Upon such payment, the principal amount of the most junior class of notes is reduced by an amount equal to such payment, having the effect of letting the note holders, and not the SPV, ultimately bear the credit risk of the Reference Portfolio up to note holders' principal amount. The unfunded part of the structure, which in this case comprises 85 % of the credit risk, consist of an unfunded credit default swap. The credit risk is transferred directly to the credit default swap counterparty, a bank incorporated in an OECD member state, with no involvement of the SPV. The OECD bank acts like a super senior tranche, as the first loss in case of any credit event in relation to the Reference Portfolio is taken up by the credit-linked note holders.



Source: *Europe Securitisation and Structured Finance Guide* <sup>56</sup>

*Example of a partially funded synthetic securitisation without an SPV*<sup>57</sup>. In this example, the funded part of the structure consists of the Protection Buyer's issuing of credit-linked notes, which are linked to the performance

<sup>55</sup> In the Sundial transaction, this sum was 37 500 000 Euro.

<sup>56</sup> Uwaifo, Elizabeth, *Europe Securitisation and Structured Finance Guide 2001*,

<sup>57</sup> This example is based on a combination of the two synthetic securitisations "HAUS 2000-2" and "Cast 1999-1", arranged by Deutsche Bank.

of a Reference Portfolio consisting of residential mortgage loans. The Protection Buyer then receives the proceeds of the issuance of the notes. His payment obligation of the principal and the interest of the notes are conditional upon the performance of the Reference Portfolio as the amount repayable reduces, starting with the junior classes, in case of credit defaults. Ordinary, the rating of the notes would be linked to the credit rating of the Protection Buyer, which can be a problem if the Protection Buyer wants to issue notes of a class having a higher rating than his own. However, if collateralising the notes, this problem can be solved. As a credit enhancement, the Protection Buyer combines the issuing of different classes of notes, letting the junior classes take the first loss, with a repayment obligation to the senior class notes. By this procedure, the senior class notes can be rated AAA even though the Protection Buyer is rated AA. The unfunded part of the synthetic securitisation consists of a credit default swap, with a credit institution incorporated in an OECD member state.

# 5 Legal Issues- Conventional Securitisation

The wide variety of transactions and the complex structure of the conventional securitisation may raise many questions regarding uncertainty in laws and regulations. In addition, as many securitisation structures are cross-border transactions, with parties in different jurisdictions, legal risks arising out of uncertainties- and unanticipated changes in foreign laws makes the structure even more complex. The legal uncertainties of the transactions involved may of course differ from one jurisdiction to another, but the origin of the legal concerns can often be traced to the same sources, which will be examined in more detail below. This chapter will therefore focus on some of the most important universal legal issues of the conventional securitisation and further study how they are dealt with in some selected jurisdictions.

## 5.1 True Sale

One of the most basic- and fundamental ideas behind securitisation consists in giving the investors rights over specific assets of the Originator without letting the Originator's performance or bankruptcy affect the investors. This necessitate that the investors or the SPV have legally acquired the assets. In securitisation, this is accomplished by a true sale to the SPV, normally through an assignment, but a novation or sub-participation might be an option. The legal separation accomplished by an effective true sale distinguishes the transaction from a secured loan, so that the assets will not be subject to the automatic stay in the Originator's potential bankruptcy.<sup>58</sup> The term "true sale" can however have different meanings in different legal areas such as Tax-, Accounting- and Bankruptcy law, and its meaning may furthermore vary from one jurisdiction to the other. In common law Property- and Bankruptcy Law, a true sale is used to define the sale and the transfer of the legal ownership of the assets, beyond the reach of the transferor's creditors.<sup>59</sup> A "true sale" will in this paper have a similar meaning, i.e. that a transfer of assets in each and every jurisdiction will constitute a valid sale and a legal transfer of the title to the assets.

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<sup>58</sup> Carlsson, Robert, *Cross-border Securitisation from a Swedish perspective*, page 3

<sup>59</sup> See for example the U.K. case *Re George Inglefield Ltd* and the U.S. case *Major's Furniture, Inc. v. Castle Credit Corp.*

## 5.1.1 Perfection

The perfection of a sale relates to the legal steps required to be taken in order to make a sale or transfer of assets effective against third parties. There are two main governing principles regarding what is considered a valid, enforceable and perfected sale in the legal systems of the world. In the U.S.<sup>60</sup>, the U.K.<sup>61</sup>, France<sup>62</sup> and in the majority of the jurisdictions of the world, a sale is perfected once a contract of sale is formed and enforceable. In Germany<sup>63</sup>, Sweden and the Netherlands<sup>64</sup> among others, the general rule is that a sale is perfected through the physical delivery of the asset.<sup>65</sup> There are however some exceptions. In Sweden<sup>66</sup>, as well as in for example France<sup>67</sup>, a sale of a *non-negotiable receivable* is perfected through a binding sale agreement, combined with the debtor being notified of the sale.<sup>68</sup> Under English law, a sale of receivables by statutory assignment will also be valid and enforceable through a binding agreement, in writing or otherwise, and perfected through debtor notification. However, the so-called equitable assignment, which only transfers the beneficial interests and not the legal property title to the asset, requires no such notification.<sup>69</sup> An equitable assignment will transfer all the economic rights of the assignor to the assignee, but the legal right to the asset remains with the assignor. Hence, the equitable assignee can for example not sue on the asset without joining the owner of the legal title as a co-plaintiff to the proceedings.<sup>70</sup> Under American law, the sale is valid and enforceable through a binding sales agreement between the legal owner and the purchaser. The filing of a UCC financing statement that identifies the seller, the purchaser and the type of receivable being sold, will furthermore perfect the American sale of non-negotiable receivables.<sup>71</sup> According to Swedish<sup>72</sup> and English law<sup>73</sup>, a perfected sale can however only relate to the seller's rights, and not the obligations, of the receivable, since such transfer requires the debtor's consent.

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<sup>60</sup> See Article 9 UCC, but note that certain security interests need to be registered in order to be effective.

<sup>61</sup> See Sale of Goods Act, Section 18

<sup>62</sup> See Article 1583 Code Civil

<sup>63</sup> According to § 929 BGB physical delivery is required, but § 930 BGB states that a sale can be perfected through a binding contract if a separate agreement, stating that the asset shall remain with the seller, is drawn.

<sup>64</sup> See Article 3.4.2.7 NBW regarding receivables

<sup>65</sup> Håstad, Torgny, *Sakrätt avseende lös egendom*, page 207 ff. and Göransson, Ulf, *Traditionsprincipen*, page 48-50

<sup>66</sup> See the Swedish Promissory Notes Act of 1936 (Sv.: Lag (1936:81) om skuldebrev), 31 §

<sup>67</sup> See article 1689 of the French Civil Code

<sup>68</sup> *The international Comparative Legal Guide to Securitisation 2005*, page 242

<sup>69</sup> See section 136 of the U.K. Law of Property Act of 1925

<sup>70</sup> See e.g. the U.K. cases of *Holroyd v. Marshall* and *Durham Bros. v. Robertson*

<sup>71</sup> See section 9-307 of the UCC

<sup>72</sup> See the Swedish Promissory Notes Act of 1936 (Sv.: Lag (1936:81) om skuldebrev), Chapter 3 § 27

<sup>73</sup> See the U.K. case of *Tolhurst v. Associated Portland Cement Mfrs.*

Regarding *negotiable promissory notes*, according to Swedish law<sup>74</sup> a sale is generally considered perfected through physical delivery, or if the promissory note is held by a third party, through third party notification.<sup>75</sup> However, where the seller is a bank or credit institution, a perfected sale can be achieved without having to transfer the possession of the promissory note.<sup>76</sup> In the U.K.<sup>77</sup> and the U.S.<sup>78</sup> a negotiable instrument is also transferred by some act of negotiation, either through delivery, endorsement, registration or a combination. Bearer instruments are transferred by delivery and registered instruments by registration in a register.<sup>79</sup> However, the American transfer and sale of promissory notes, which includes for example residential- and commercial mortgages, are automatically perfected through the sales agreement. A filing of a UCC financing statement or a physical delivery is therefore not needed, although such actions can have some effects if issues of priorities in the asset arise.<sup>80</sup>

## 5.1.2 Risk of reclassification

The importance of the true sale in a securitisation lies within the line of distinction it makes between securitisation and collateralised lending. In those jurisdictions that perfect their sale by the mere formation of the binding contract, and not by physical delivery or notification, the question whether a true sale has taken place or not is especially important.<sup>81</sup> But where these jurisdictions can create a legal separation from the Originator with an effective true sale<sup>82</sup>, and still let the Originator have control over the assets, countries which apply the principle of perfection by physical delivery faces difficulties. The importance of letting the Originator act as an Administrator, with powers of active management over the asset pool, is vital for many securitisation structures. This is made difficult when physical delivery or notification is required for an effective true sale.<sup>83</sup>

There are mainly three elements in the Anglo-American securitisation structure that could cause a reclassification. *Firstly*, even though there is a true sale of the asset pool to the SPV, it is common for the Originator to have an option or right to request that the receivables can be re-transferred

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<sup>74</sup> See the Swedish Promissory Notes Act of 1936 (Sv.: Lag (1936:81) om skuldebrev), Chapter 2 § 22,

<sup>75</sup> Mellqvist, M., Persson, I., *Fodran & Skuld*, page 108-109

<sup>76</sup> See the Swedish Promissory Notes Act of 1936 (Sv.: Lag (1936:81) om skuldebrev), Chapter 2 § 22

<sup>77</sup> See the U.K. Bills of Exchange Act 1882.

<sup>78</sup> See the U.S. Article 3-4, UCC

<sup>79</sup> *The international Comparative Legal Guide to Securitisation 2005*, page 78 and 263-264.

<sup>80</sup> See UCC art. 9 and *The international Comparative Legal Guide to Securitisation 2005*, page 263-264

<sup>81</sup> Ds 1998:71, *Better Conditions for Securitisation* (Sv.: *Bättre förutsättningar för värdepapperisering*), page 71

<sup>82</sup> A True Sale can be effected in law or in equity through an legal or equitable assignment, a novation, a declaration of trust or a sub-participation (*Basel Committee on Banking Supervision, 2004*).

<sup>83</sup> Månsson, Fredrik, *Värdepapperisering*, page 80-81

to the Originator by the end of the maturity of the asset-backed notes, bonds etc. issued by the SPV. Such an option could have the effect of preventing the Issuer from disposing of the assets and contributes to the conclusion that the transaction could actually be a secured loan.<sup>84</sup> *Secondly*, it is also common for the Originator to give the SPV and its investors some sort of limited guarantee to reduce their credit risk and to enhance the credit rating of the notes issued by the SPV. This means that in the case of a credit default by one of the receivables in the asset pool, the Originator could still suffer a limited loss as a result of the remaining credit risk of the Originator.<sup>85</sup> *Thirdly*, as already mentioned the Originator often keeps former client relations and treats the debtors of the receivables in the same way as any other client. To the debtors, this may contribute to the impression that the Originator still has the legal ownership of the asset pool.<sup>86</sup>

Summarising the above elements of commercial- and legal relations between the Originator and the SPV, there is an evident risk of reclassification according to most common- and civil law structures. However, common law jurisdictions have two major advantages when avoiding a reclassification. *Firstly*, a sale of assets is generally perfected and valid against third parties through the formation of a valid sales agreement, and no physical delivery is required. Regarding the sale of receivables, the common law Originator can perfect the sale through a U.S. filing of a UCC financial statement or an U.K. equitable assignment or registration, and furthermore perform his administrative duties without being obstructed by multiple debtor notifications. *Secondly*, through the so-called “two-step”-, or two-tier, procedure, common law jurisdictions have the means of further improving the legal separation from the Originator. In the procedure the Originator first transfers the assets to an intermediate SPV that is a wholly owned Originator subsidiary, has at least one independent director, and is only permitted to engage in the business of acquiring, owning and selling the assets. In the second step, the intermediate SPV sells the assets to the Issuer SPV, which is either structured as a trust (this is common in the U.S.) or as a corporate SPV, where the beneficial ownership of the shares are held by a trustee. The underlying assets of the corporate SPV will furthermore be assigned to a security trustee, to be held in trust for the benefit of the investors. The trust, which will be further explained in Section 5.3, ensures an independent governance of the SPV and the assets, with no influence or control of the Originator, and the true sale characteristics of the transaction are thereby improved. Civil law jurisdictions, on the other hand, generally

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<sup>84</sup> Also see the definition of a “clean break” in the Swedish Financial Services Authority’s (Sv.: Finansinspektionens) regulations regarding securitisation which prohibits major credit risk guarantees (FFFS 2001:7, Chapter 2 §§ 8 and 9)

<sup>85</sup> Also see the definition of a “clean break” in the Swedish Financial Services Authority’s (Sv.: Finansinspektionens) regulations regarding securitisation which limits the possibilities of buy-back options (FFFS 2001:7, Chapter 2 § 2).

<sup>86</sup> Månsson, Fredrik, *Värdepapperisering*, page 74-81 and The international Comparative Legal Guide to Securitisation 2005, page 243

lack the concept of trust with its advantages of a reliable and independent governance structure.<sup>87</sup>

A court exercising a substance-over-form reasoning<sup>88</sup>, will look at all the elements explained above in its decision whether the relation between the Originator and the SPV and the assets are of such extent to constitute a reclassification. If the purpose of a transfer really is to create a security interest, rather than to transfer ownership, a court will most likely classify the transfer as a secured loan, disregarding the title of the contract given by the parties.

In a court decision of the Swedish Supreme Court<sup>89</sup>, it was determined that a financial institution that assigned assets with attached lease agreements to a third party could still act as an administrator of the assets. In this case, the transferor assigned several assets on lease with attached receivables contracts to the transferee, but the transferor kept some of his administrative duties in relation to its former debtors. Furthermore, on the assignment date, the leasing customers/debtors physically possessed the leasing objects. The debtors were notified about the assignment and the fact that the transferor would still be able to for example collect payments. When the transferor went insolvent, the question arose whether the assets transferred would be subject to an automatic stay in the transferor's bankruptcy or not. In determining whether a true sale of the assets had taken place or not, the court looked at both the assignment of the leasing objects and the future cash flows from the leasing agreement. Factors like the transferors remaining administrative duties, the separation of the cash flows and the notification of the assignment to the debtors were all taken into consideration. In their judgement, the Supreme Court first said that if the assignment of the lease objects were to be considered perfected, so should the assignment of the future cash flows. The court then stated that although the right of the transferor to control the cash flows and the economic relations with the debtors were not actually transferred, the mere notification to the debtors that an assignment had taken place had legally separated both the leasing objects and the receivables contracts from the transferor. As the transferee at any given time could withdraw the remaining rights of the transferor through a new debtor notification, and since the transferor had no possibility to for example pledge or assign the assets, the assignment was considered legally perfected.

Even though this decision throw some light on the uncertainties regarding the consequences of letting the transferor keep his administrative responsibilities, this case can to some extent be distinguished in relation to securitisation. In this case, the notification to the leasing customers replaced

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<sup>87</sup> See section 5.3

<sup>88</sup> For example Swedish and British courts have a strong tradition of substance over form reasoning. In the British case *Orion Finance Limited v. Crown Financial Management Limited*, Millett LJ said that: "the question is not what the transaction is but whether it is in truth what it purports to be."

<sup>89</sup> NJA 1995 s. 367

the normal requirement for perfection through physical delivery, as the lease objects were neither in the physical possession of the transferor or the transferee. The Supreme Court judgement does however not deal with the subject of remaining administrative duties of the transferor when simply assigning receivables that traditionally are perfected through notification. Furthermore, in securitisation, the Originator's duty to, for example, continue collecting payments from the creditors is only one of many circumstances that might result in a reclassification of the asset transfer. Other factors, like a residual interest in the assets through a buy-back option or the remaining economic interest in the assets through credit enhancing guaranties, were not actually discussed in the Swedish Supreme Court case, which limit the importance of the decision in relation to the conventional securitisation.

Hence, in order to avoid uncertainties regarding reclassification, the parties have to make sure that the purchaser, the SPV, is not prevented from disposing of the assets transferred and to ensure that the seller does not have a preferential claim to the receivables in case of the purchaser's bankruptcy.<sup>90</sup>

## 5.2 A Clean Break

The issue of bankruptcy remoteness of the SPV, a "clean break" of the assets from the Originator and the question whether a true sale has taken place or not, are all closely connected. But whilst a true sale of the assets and an ensured bankruptcy remoteness of the SPV ensure that the assets are legally separated from the Originator according to Bankruptcy Law, a clean break is a term used to define the final separation of the credit risk. The term "a clean break" of the assets is therefore not used to describe the legal separation of the assets from the Originator's potential bankruptcy according to Insolvency- and Bankruptcy Law, but rather a description used by rating agencies and bank regulators to define that the credit risk has passed to the SPV.

In order to remove the assets from the Originator's risk-based capital ratio calculations, it is necessary to ensure that a clean break between the Originator and the securitised assets has been completed. A true sale, which legally separates the assets from the Originator and his insolvency, is a requirement for a clean break, but in order to completely remove the credit risk of the assets from the Originator's balance sheet, other factors also have to be taken into consideration. The relations between the Originator and the Issuer must be minimised to prevent insolvency from either party to affect the other, and to prevent a lift of the corporate veil. Rating institutes and government authorities often outline different guidelines, which the

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<sup>90</sup> Månsson, Fredrik, *Värdepapperisering*, page 79-80 and *The international Comparative Legal Guide to Securitisation 2005*, page 243

Originator and the SPV have to follow in order to get their transaction rated as an off-balance sheet transaction. This means, that even if the transaction otherwise would be treated as a true sale under the home country's accounting or legal system, rating institutes and financial supervisory authorities could still treat the securitised assets as remaining in the Originator's risk-weighted assets, if a clean break can not be confirmed.<sup>91</sup>

## 5.2.1 Regulations and Guidelines

According to a consultative documents on asset securitisation issued by the Basel Committee<sup>92</sup> and the new Basel II, three minimum criteria have to be followed in order to affect a clean break. *Firstly*, the transferred assets must have been legally isolated from the transferor and his creditors, and the bankruptcy or receivership-satisfaction of this element is to be supported by a legal opinion. *Secondly*, the transferee must be a qualified SPV and the holders of the beneficial interests in the SPV must have the right to pledge or exchange these interests. *Finally*, the transferor must not maintain effective- or indirect control over the transferred assets. Although not legally binding, these guidelines from the Basel Committee have a big authority in the financial market, and the criteria for a clean break are furthermore often reflected in national legislation.<sup>93</sup> For example, the Swedish Financial Services Authority (FSA) have published various legally binding<sup>94</sup> regulations on securitisation, a clean break and an affective risk transfer, which largely are attuned with the rules from the Basel committee.<sup>95</sup> Besides stipulating that a valid transfer of the assets to an SPV have to take place in order to affect a clean break, the regulations from the Swedish FSA have detailed definitions of the Originator's "effective- or indirect control over the assets". According to these regulations, the Originator shall not own any shares or in any way have any major economic interests or influence in the ownership of the SPV.<sup>96</sup> The fact that the Originator has appointed a minority of the SPV's board of directors is however not considered as a major influence. Furthermore, the name of the Originator must not in any way be reflected in the name of the SPV in such a way that the two separate companies could be associated with each other.<sup>97</sup> Last, the Originator must not contribute to the financing of the SPV,

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<sup>91</sup> *Basel Consultative Paper on Capital Adequacy and its Proposals for Securitization* by Mayer, Brown, Rowe & Maw LLP

<sup>92</sup> *Basel Committee on Banking Supervision: A consultative document on Asset Securitisation*

<sup>93</sup> See Allen, Linda, *The Basel Capital Accords and International Mortgage Markets: A Survey of the Literature* and *Basel Committee on Banking Supervision: A consultative document on Asset Securitisation*

<sup>94</sup> See FFFS 2001:7 and § 1 in the Swedish ordinance "(2000:669) om kapitaltäckning och stora exponeringar för kreditinstitut och värdepappersbolag".

<sup>95</sup> *General Guidelines and Regulations regarding Securitisation* (Sv.: Finansinspektionens föreskrifter och allmänna råd om värdepapperisering), FFFS 2001:7.

<sup>96</sup> Chapter 2 § 3 FFFS 2001:7

<sup>97</sup> Chapter 2 § 4 FFFS 2001:7

or own any securities issued by the SPV, for any other purpose than giving credit enhancement.<sup>98</sup> The British FSA<sup>99</sup>, as well as e.g. the Bank of England<sup>100</sup>, the German regulatory authorities<sup>101</sup>, the Board of the International Accounting Standards Committee<sup>102</sup> and the American Financial Accounting Standards Board<sup>103</sup> have also published similar regulations and guidelines on the definition of a clean break. These rules also focus on legal separation, full economic separation between the Originator and the SPV, with the exception of limited credit enhancement, and a full presentational, influential and moral separation between the two entities.

## 5.3 Trustee management

Trusts are increasingly being used as financial tools in a wide range of commercial- and financial transactions all over the world. The distinctive characteristics of the trust regarding governance, legal separation, special tax treatment and bankruptcy remoteness have made trusts especially interesting in e.g. structured finance and securitisation, but also as a foundation in structuring mutual funds and investing pension funds, where stability and certainty are important. The trust is especially important in securitisation as it provides an independent governance of the SPV, without any influence of the Originator, and thereby reduces the relations between the two parties. This chapter will briefly explain the concept of trust, its functions in a securitisation structure and look at some civil law trust-like institutions.

### 5.3.1 Concept of Trusts

The trust is one of the most ingenious and frequently used contributions of the English legal system to the law. With its origin in the 11<sup>th</sup> century, the trust has developed to play an important role in all the common law legal systems of the world, but it has no direct equivalent in civil law jurisdictions. The trust is a product of the English law of equity and was originally created to provide a flexible and stable legal tool for asset management when passing on estate inheritance.<sup>104</sup> Different variations of

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<sup>98</sup> Chapter 2 § 5 FFFS 2001:7

<sup>99</sup> Interim Prudential Sourcebook: Banks, Article 2.2-2.3, U.K. FSA 2000

<sup>100</sup> See the “*Amendments to Policy on Loan Transfers and Securitization*” issued in a consultation document by Bank of England’s Supervision and Surveillance Division

<sup>101</sup> Bundesaufsichtsamt für das Kreditwesen, Circular Letter, May 1997

<sup>102</sup> See Section 39 IAS

<sup>103</sup> See Section 140 FAS

<sup>104</sup> Bogdan, Michael, *Komparativ rättskunskap*, page 116-117

the trust have however unfolded, where the U.S. especially stand out with its more entity-based trust structures. A trust is created by the separation of assets to a person, the trustee, who becomes the legal owner of the assets. He has a legal duty to administer the assets in accordance with the predetermined purpose of the trust and must also satisfy the interests of the beneficiaries of the trust. The trust can be described as an equitable obligation, binding the trustee to deal with property over which he has control, for the benefit of other persons.<sup>105</sup> It is fiduciary relationship with respect to the trust property, arising as a result of an intention or an agreement to create that relationship and subjecting the trustee to duties to deal with it for the benefit of third party beneficiaries. Trust law effectively make use of the dual ownership characteristics of common law<sup>106</sup>, and divides the ownership of the trust assets into two different legal titles: legal and equitable ownership. The legal ownership, held by the trustee, involves the control, management and the possession of the trust property, while the equitable ownership of the beneficiaries involves the benefit and use of the assets. Due to this split ownership between the trustee and the beneficiaries, the trust relationship provides for an effective limited liability: beneficiaries of the trust can claim only against the true assets and not against the trustee's personal assets. Nor can the trustee's personal creditors claim against the trust assets. The trust does thereby distinguishes itself from any other legal entity or legal instrument in its unique combination of flexible and effective governance together with a static and safe placement from an investor- or beneficiary perspective.<sup>107</sup>

In the U.S. and the U.K., trusts used for commercial purposes, i.e. commercial trusts, have become a primary tool when managing and separating assets in a securitisation structure. Unlike the historical standard trusts, i.e. trusts used for gratuitous purposes, a party who transfers assets to a commercial trust, the settlor, will always receive payment for the assets passed on to the trust. Furthermore, he will also retain a residual interest entitling him to retain any assets in the trust once the transaction is over, a fact that could cause problems regarding the bankruptcy remoteness of the SPV in securitisation.<sup>108</sup> When an SPV in a securitisation structure has raised the funds to acquire the asset pool from its investors, it purchases the assets from the Originator. Consequently, the Originator will retain a residual interest in those assets if the SPV is structured as a commercial trust. As different jurisdictions have different views on whether trusts are

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<sup>105</sup> Burn, E.H., *Trusts and Trustees*, page 5

<sup>106</sup> Common law divides property rights into legal and equitable ownership. The beneficiaries are the holders in equity of the beneficial interest given to them, whilst the trustees are the legal owners of the assets. The ownership of the trustee is wholly burdensome, it obligates them to manage the property in the exclusive interest of the beneficiaries and imposes onerous duties and liabilities on them. See Burn, E.H., *Trusts and Trustees*, page 3-5

<sup>107</sup> Schwarcs, Steven L., *Commercial Trusts as Business Organizations: An Invitation to Comparatists* and Burn, E.H., *Trusts and Trustees*, page 5-6

<sup>108</sup> Schwarcs, Steven L., *Commercial Trusts as Business Organizations: Unravelling the Mystery*, page 5 ff

separate legal persons or not<sup>109</sup>, the Originator's residual interest could cause ambiguity regarding the ownership of the assets, in case of Originator insolvency. In order not to compensate the true sale criterion of the securitisation structure, this problem is therefore solved by the two-step procedure<sup>110</sup>. The first step, a transfer of the assets to a corporate intermediate SPV, is followed by the transfer of the assets to a trust entity, alternatively to an SPV with all its shares held in trust by a Security Trustee, with a separate trustee representing the investors. According to this structure, the U.S.- and the U.K.- bankruptcy- and insolvency laws, as well as rating agency standards, will treat the assets as separated from the Originator and the true sale characteristics of the transaction are not jeopardised.<sup>111</sup>

### 5.3.2 Governance of the Trust

During the trust period, the trustee acts for the benefits of the beneficiaries, but he is not subject to the control of neither the beneficiaries, nor the Originator. With respect to third parties, the trustee has legal ownership of the trust property, but at the same time, *in personam* property rights of the beneficiaries are created through the split ownership of the trust assets. This allows for a very flexible governance of the trust assets, without endangering the property rights of the parties involved. Another virtue of the trust and the trustee, as far as the securitisation structure concerns, are the several legal duties that are imposed on the trustee as a result of the trust relationship, that for example requires the trustee to act skilfully, in good faith and in accordance with the purpose of the trust.<sup>112</sup> One of the most important examples of these duties is the fiduciary duty, which obliges the trustee to act in good faith<sup>113</sup> and avoid conflict of interests in which the potential benefit of the fiduciary is in conflict with what is best for the beneficiaries<sup>114</sup>. The trustee must always act with the proper motive, and is thus forbidden to be in situations of conflicting motivational demands.<sup>115</sup> Another example is the trustee's so-called duty of impartiality, which in case of multiple beneficiaries requires the trustee to deal with the

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<sup>109</sup> Under U.K. law, trusts are not treated as legal persons, while most commercial trusts are treated as separate legal persons in the U.S. This means that when the trust performs particular functions such as holding property, enters into contracts and sues or being sued, the U.S. trust can do it in its own name, whilst the U.K. trust does it in the names of trustees.

<sup>110</sup> Also see section 4.1.2

<sup>111</sup> Schwarcs, Steven L., *Commercial Trusts as Business Organizations: An Invitation to Comparatists* and Burn, E.H., *Trusts and Trustees*, page 5-6

<sup>112</sup> Bogert, George T., *Trusts*, page 334 ff

<sup>113</sup> See the British case *Re Second East Dulwich*

<sup>114</sup> See for example the British case *Keech v. Sandford*

<sup>115</sup> Smith, Lionel, *The Motive, not the Deed*, 2003 (SSRN)

beneficiaries impartially.<sup>116</sup> However, both according U.K. and U.S. trust law, it is possible for the parties of a trust to contractually exempt the trustee from some of his duties. Duties that refer to the liability of the trustee due to negligence or lack of diligence can generally be exempted, whilst duties that requires the trustee to act honestly or in good faith represent an irreducible core of obligations that cannot be avoided.<sup>117</sup> Hence, in both the U.K. and the U.S. it is possible to create a trust which does not impose a duty on the trustee to take reasonable care, but not a trust which do not impose a fiduciary duty on the trustee to act loyal, honestly or in good faith.<sup>118</sup>

In securitisation, the fiduciary duty and the duty of impartiality of the trustee complements each other as particularly important governance characteristics of the trust. As the expectations from the beneficiaries of the securitisation trust are for the trustee to preserve the value of the trust assets, the fiduciary duties of the trustee will make sure that the trust act as a static entity with passive managers. This is a big difference compared to a company governance structure, whose managers often need to be aggressive and take advantage of business opportunities. Companies by nature have a conflict of interest<sup>119</sup> between the shareholders demanding increased profitability and not merely preservation of corporate value, and the creditors who are concerned that risks taken to achieve profitability might lead to corporate insolvency. Trusts and trustees however, according to the U.S. and the U.K. trust laws, have a duty to both act in the best interest of the beneficiaries and in addition, in case of two or more beneficiaries of a trust, to deal with them impartially. This limits the ability of the trustee to gain residual claimants by taking risks in order to make the trust profitable, if it is at the investor's possible expense. This way conflicts of interests between investors and possible residual claimants can be avoided and the trustee in a securitisation structure settles with preserving the value of the assets.<sup>120</sup>

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<sup>116</sup> In the U.S. the duty of impartiality is expressed in the *Restatement (3<sup>rd</sup>) of Trusts*, §183 at 149. In the U.K., the same principle can be found in the *Trustee Act 2000*, Part 2 Section 3-7 and derived from the case *Speight v. Gaunt*

<sup>117</sup> In the U.K., the British case *Armitage v. Nurse* states that an exemption clause can effectively exempt a trustee from liability for loss or damage to the trust property “no matter how indolent, imprudent, lacking in diligence, negligent or wilful he may have been, so long as he has not acted dishonestly”. In the U.S., it is possible to exempt the trustee from liabilities due to lack of diligence, but an exemption clause which excludes the trustee from liabilities due to gross negligence is considered to be against public policy and unenforceable. See the Committee on the Modernization of the Trustee Act's consultation Paper titled “*Exculpation Clauses in Trust Instruments*”.

<sup>118</sup> See the U.K. Law Commission's consultation paper titled “*Trustee Exemption Clauses*”, January 2003, the Committee on the Modernization of the Trustee Act's consultation Paper titled “*Exculpation Clauses in Trust Instruments*”, October 2000 and Bogert, George T., *Trusts*, page 337-347

<sup>119</sup> E.g. see the presumption of profiting of the shareholders in the Swedish Corporation Act of 2005 (Sv.: Aktiebolagslagen (2005:551) Chapter 3, § 3

<sup>120</sup> Schwarcs, Steven L., *Commercial Trusts as Business Organizations: An Invitation to Comparatists* and Bergström, Samuelsson, *Aktiebolagets grundproblem*, Page 188 ff.

### 5.3.3 The importance of Trusts in Securitisation

The main attraction of using trusts and trustees in securitisation structures is their superior governance characteristics. Since the value of the assets in a securitisation of receivables can be predicted with reasonable accuracy and the value is unlikely to increase, the common goal of all beneficiaries is to preserve the value of the assets and thus protect their interests. The fiduciary duty and the trustee's duty of impartiality thereby work as an efficient protection of all investor interests. Furthermore, when a trustee holds the assets in trust, they are legally separated from both the Originator's- and the trustee's creditors. This improves the bankruptcy remoteness of the SPV and thereby increases the credit rating of the issued notes.<sup>121</sup>

### 5.3.4 Trusts in Civil Law Countries

In civil law countries, the concept of trust has traditionally not existed. The modern trust has gradually developed within the Anglo-American legal system and its characteristics have proven to be very useful in a variety of different financial structures. Because of trust's importance in structured finance, some civil law countries have adopted legislation that more or less incorporates the concept of trust in their legal system. Legislators in Italy have introduced an institution by which a party can transfer the ownership of a specific asset to a manager. The manager then contractually manages the asset as the transferor's agent for the benefit of third parties appointed by the transferor. A similar legislation has been adopted in Switzerland and Germany, but none of these trust-like institutions can completely be considered as adequate equivalents to the common law trust. One major reason for this inadequacy is the non-existing concept of split ownership into legal and equitable titles in civil law jurisdictions. This separation of the trust assets, which excludes them from the trustee's own estate, works as an effective protection for the beneficiaries and at the same time offers the trustee great freedoms in his asset management. An elucidative illustration of this is the case of breach of trust from the trustee. If the common law trustee acts in bad faith and transfers the assets to a third party, the beneficiaries are fully protected and can claim a recovery of all the assets due to their ownership and title in the assets. However, if the manager in a civil law country acts in breach of trust, recovery cannot always be guaranteed, and the scope of protection is generally not as broad as that afforded by the common law trust.<sup>122</sup> Other civil law jurisdictions have taken the incorporation of trust law one step further by enacting special trust laws, with the purpose of complete incorporation of the common law trust

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<sup>121</sup> Schwarcs, Steven L., *Commercial Trusts as Business Organizations: An Invitation to Comparatists* and Frankel, Tamar, *Cross-Border Securitization: Without Law, But Not Lawless*

<sup>122</sup> Hansmann & Mattei, *The Functions of Trust Law*, page 435-36

by means of statute<sup>123</sup>. Such laws often incorporate not only the trust as a separate legal entity, but also try to imitate liabilities and fiduciary duties of the trustee, as well as the division of ownership between the beneficiaries and the trustee. For example, the Japanese trust law states that the trustee is the sole owner of the trust assets, but at the same time, the trust- and insolvency law excludes the assets from the trustee's personal insolvency.<sup>124</sup>

Swedish law has not accepted the concept of trust. Although several special, and separately regulated, institutions and entities<sup>125</sup> have been implemented by law to fill up the gap that is created in the financial world due to the absence of trust law, none of these has managed to completely replace the use of a trust. In order to assure an independent governance of the SPV, a securitisation structured in Sweden with a Swedish SPV is referred to use a Foundation. The Swedish foundation is however not suitable to use as an SPV, but rather as the shareowner of the corporate SPV. This is so, because the Swedish Foundation Act (Sw.: Stiftelslagen) states that the purpose of a foundation is to administer and hold separate assets in trust on a long-term basis, and most SPVs are only used for the purpose of one securitisation procedure.<sup>126</sup> Nevertheless, the Swedish foundation comprises some of the important virtues that are required to assure legal separation of the asset in a securitisation structure. A foundation is a separate legal entity, created by the detachment of specific assets that are to be administered as a separate entity for a single purpose.<sup>127</sup> The foundation's managers are bound to administer the assets in such a way that the pre-determined purpose, established by the initiators, is fulfilled. Hence, the governance structure, the legal status and the focus on separation of the assets makes the foundation suitable when perfecting a true sale according to legal, regulatory and rating agency standards. However, like other trust-like institutions in civil law countries, the Swedish foundation is not a completely adequate replacement of the common law trust. The Swedish foundation both lack the governance flexibility and some of the characteristics of the trust that works as a protection for the beneficiaries and transferors as a result of the split ownership. If, for example, the SPV managers act in breach of trust and the contractual obligations imposed on them, the SPV investors will not have the same protection as a common law trust would give them, as the possibilities to recover assets are more limited.<sup>128</sup>

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<sup>123</sup> E.g. the Chinese "Trust Law of the People's Republic of China", passed in 2001, Liechtenstein's "Law Concerning the Trust Enterprise" or the Japanese Trust Law "Shintakugyou-hou"

<sup>124</sup> Toyohara, Pitts and Raftery, *Trusts and Banking* and Stroll and von Arx, *Switzerland: Trusts*

<sup>125</sup> For example, see the Swedish "Fondbolag" or "Värdepapperscentral"

<sup>126</sup> Chapter 1 § 2, Swedish Foundation Act (Sv.: Stiftelslagen) (1994:1220)

<sup>127</sup> Chapter 1 § 2, Swedish Foundation Act (Sv.: Stiftelslagen) (1994:1220)

<sup>128</sup> Månsson, Fredrik, *Värdepapperisering*, page 82-83 and Isoz, Henning, *A commentary to the Swedish Foundation Act* (Sv.: Stiftelslagen: en kommentar), page 26-34

## 5.4 SPV regulations

The purpose of securitisation is to release risk-based capital and to achieve a lower fund cost for the securitised assets. With complicated SPV regulations and licensing requirements, compliance with these requirements may increase the funding costs to an extent that renders the whole transaction financially unsuitable.<sup>129</sup> Hence, the choice of location and jurisdiction of the SPV could be crucial for the profitability of the securitisation structure.

### 5.4.1 Regulations for establishment

Internationally most securitisation structures use an SPV organised as a corporation, a limited liability company or a trust.<sup>130</sup> This means that, although the SPVs are only considered as financial devices in terms of securitisation, they are still real legal entities with separate legal identities, and have to follow the laws and regulations of their incorporation.<sup>131</sup> Sweden does not have any specific laws or regulations providing for the establishment of SPVs, but instead the legislators have chosen to organise Swedish SPVs as limited liability companies.<sup>132</sup> SPVs therefore, like any other company, need to keep statutory books, make statutory filings of audited accounts, tax returns and other corporate matters. Other countries, like the Netherlands, the U.K., Germany, the U.S. and the Island of Jersey have also chosen not to set up any specific laws for the establishment of an SPV, whilst countries like France, Spain and Portugal have created new regulations for the establishment of bankruptcy remote SPVs.<sup>133</sup>

### 5.4.2 License requirements

Throughout the legal systems of the world, there are numerous different rules and regulations concerning the activity of lending. In for example cross-border securitisation, this means that the lender, i.e. the issuing SPV, must not only make sure that he has the proper authority to initiate lending activities, but also that the rules in each jurisdiction in which a borrower is located are followed, to ensure that an SPV is legally entitled to lend in the jurisdiction.<sup>134</sup>

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<sup>129</sup> Albrecht, Thomas W, *Corporate Loan Securitization: Selected Legal and Regulatory Issues*, page 18

<sup>130</sup> Månsson, Fredrik, *Värdepapperisering*, page 79-80 and *The international Comparative Legal Guide to Securitisation 2005*, page 266-267

<sup>131</sup> Raikes, Anthony, *The management of special purpose companies*

<sup>132</sup> See the Swedish "Lag (2004:297) om bank- och finansieringsrörelse" Chapter 2 §3

<sup>133</sup> *The international Comparative Legal Guide to Securitisation 2005*

<sup>134</sup> However, if the cross-border lending activity is conducted inside the EU, the so-called "single passport" grants financial firms the right to operate throughout the EU subject to the regulations of their home country. See the *Second Banking Coordination Directive of 1989* and the *Investment Services Directive of 1993*.

Under Swedish law, all companies conducting in “banking- or financing businesses” (Sw.:/ “Bank- och Finansieringsrörelse”) must hold a license.<sup>135</sup> Since SPVs in a typical securitisation structure acquire debts and raise repayable funds from the public, the SPV is deemed to be conducting financing business,<sup>136</sup> and, as mentioned in Section 2.1, banks and credit institutions that conduct in financing business are required by law to hold a certain amount of regulatory capital in liquid funds. However, Swedish legislators have recently issued a licensing exception for securitisation SPVs, in order to avoid SPVs being affected by regulatory capital requirements. But the exception applies only to SPVs that conduct in acquiring receivables for a limited number of times<sup>137</sup> (about three times), which for example excludes securitisation transactions with short maturity receivables, acquired on a revolving basis.<sup>138</sup> The Swedish SPV regulations correspond with the EU legislation<sup>139</sup> that requires all EU member states to regulate credit institutions. According to the directive, credit institutions that conduct businesses in a member state must be authorised by the Member States’ Financial Supervisory Authorities. However, following to Swedish governmental declarations, an SPV located in a member state, which acquire receivables for a limited number of times, will in all probabilities fall outside the definition of a credit institution according to the directive and not be subject to the licence or authorisation requirements of the directive<sup>140</sup>.

In countries, as for example the U.K., SPVs with an asset pool consisting of corporate loans and other receivables, are generally excluded from the licence requirements applying to traditional lenders and are not subject to any regulatory capital requirements.<sup>141</sup> British and American law has primarily focused the licence- and regulatory capital requirements on those traditional credit institutions that raise their funds through deposits from the public.<sup>142</sup> There is however an authorisation requirement for parties carrying out “investment businesses” under the Financial Services Act of 1986 (as amended) in the U.K. But the asset-backed notes issued by the Issuer in a securitisation are generally structured as full recourse debt obligations of the Issuer, with the investor’s right to payment being secured on all of the assets of the Issuer. As a result, the mere issuing of these relatively safe securities has been exempted from the definition of engaging in investment businesses.<sup>143</sup> In the U.S., the general rule is that the purchase of receivables

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<sup>135</sup> See the Swedish ”Lag (2004:297) om bank- och finansieringsrörelse”

<sup>136</sup> *The international Comparative Legal Guide to Securitisation 2005*, page 244-245

<sup>137</sup> See the Swedish ”Lag (2004:297) om bank- och finansieringsrörelse” Chapter 2 §3

<sup>138</sup> Prop. 2002/03:139, page 242-244

<sup>139</sup> EU-directive 2000/12/EC, March 20, 2000

<sup>140</sup> Prop. 2002/03:139, page 242-243

<sup>141</sup> SPVs dealing with real estate mortgages in the U.K. might however require authorisation from the British FSA, see the FSA publication *Mortgages: Conduct of Business Sourcebook*

<sup>142</sup> See Section 3-6 of the British Banking Act and Section 19 of the U.S. Federal Reserve Act

<sup>143</sup> Bonsall, David C., *Securitisation*, page 40-41 and Raikes, Anthony, *The management of special purpose companies*

does not require a licence, but there might be exceptions from this rule from state to state. An excessive quantity of the lending in the same state may also trigger business legislation on state level, forcing the SPV to register its business with a state agency.<sup>144</sup> Furthermore, through amendments in 2004 of the U.S. Securities Act of 1933, some asset- and mortgage-backed securities issued by the SPV might require registration, depending on the SPV structure and the connection between the Issuer and the Originator.<sup>145</sup>

## 5.5 Bankers Duty of Confidentiality

A securitisation structure includes a number of parties who need to access information concerning the underlying assets. Rating agencies, SPV directors and trustees are only a few examples of parties that might have to access information held by the Originator. However, the information may be confidential, as many legal systems impose a duty of confidentiality between the bank and its customers. Civil law jurisdictions often enforce a duty of confidentiality under the civil code or under general principles of constitutional law<sup>146</sup>. In common law jurisdictions, the duty of confidentiality derives from the contractual relationship between a bank and its customers<sup>147</sup>. Both common- and civil law jurisdictions do however permit exceptions to this duty e.g. if the customer expressly or impliedly permits disclosure or if disclosure is required in the interest of the bank, but none of these exceptions have officially been declared applicable in a securitisation structure. The duty of confidentiality especially causes problems if the asset pool consists of corporate loans from smaller, unlisted companies, as corporate entities that list their stock on public exchanges are generally obligated to file their annual audited accounts and disclose them with a public authority.<sup>148</sup>

## 5.6 Civil law Securitisation Acts

To overcome some of the legal issues explained above, a number of European countries have issued special securitisation acts to encourage the use of securitisation. Some of these legislations will be addressed below.

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<sup>144</sup> Ibid.

<sup>145</sup> Nolan, Anthony R.G., *Bank Regulatory Issues in Securitisation and Credit Derivatives*, page 50

<sup>146</sup> Under Swedish law, the duty of confidentiality between banks and its customers is stated in Chapter 1, § 10, "Lag (2004:297) om bank- och finansieringsrörelse".

<sup>147</sup> See the case *Tournier v. Nat'l Provincial and Union Bank of England*. In the U.S., the Privacy Act of 1999 also imposes certain statutory duties of confidentiality on banks and credit institutions.

<sup>148</sup> Albrecht, Thomas J., *Corporate Loan Securitisation: Selected Legal and Regulatory Issues* and Nial, Håkan, *Bank sekretessen*, page 62-75

In *Italy*, a law has been passed<sup>149</sup> which allows for the securitisation of receivables through a thinly capitalised SPV. The act exempts SPVs from the general rule that Italian companies can only issue debt up to the amount of its nominal capital. Furthermore, the act provides that an assignment of receivables to an SPV is perfected by the publication of the sale in the Italian official gazette, rather than by notification to each individual debtor. In *France*, legislation regarding securitisation was issued already in 1988, but these regulations have been improved several times through different amendments<sup>150</sup>. Through a special type of SPV (called “Fonds communs de créances”) units, which represent a claim for payment of the proceeds from the SPV’s assets in favour of the unit holder, can be issued. A special management company manages the SPV and either the Originator or a credit institution can act as a servicer. In *Portugal* the Securitisation Law of 1999<sup>151</sup> provides for the creation of two types of SPVs (Securitisation Funds and Securitisation Corporations) which are the only entities that can purchase assets and issue asset backed notes under the Securitisation Law. The SPVs are subject to several regulatory requirements and authorisations and shall be arranged only as limited liability companies incorporated in Portugal. Other countries, which have enacted special securitisation legislations, are e.g. *Spain*<sup>152</sup> and *Greece*<sup>153</sup>. So far, *Sweden* has not chosen to pass any specific laws for securitisation. Instead, in order to support the use of securitisation, Swedish legislators have made several changes and amendments to existing laws. As mentioned in Section 5.1.1, an amendment in the Swedish Promissory Notes Act now allows credit institutions to perfect sales of negotiable promissory notes without actually transferring the assets physically. Furthermore, as explained in Section 5.4.2, an amendment to Swedish banking regulations has in certain situations made it possible for Swedish SPVs to engage in securitisation without being subject to regulatory capital requirements.

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<sup>149</sup> The Italian Law Nr. 130 of April 4<sup>th</sup> 1999

<sup>150</sup> The most important being “The loi de sécurité financière n°2003-706 of August 1, 2003

<sup>151</sup> Decree/Law nr. 453/99

<sup>152</sup> Royal Decree 926/1998 of 1998, the Spanish Finance Act of 2002 and the new Insolvency Act of 2003

<sup>153</sup> Law L3156/2003

## **6 Legal Issues – Synthetic Securitisation**

The synthetic securitisation works as a kind of default insurance for credits that remain on the Protection Buyers balance sheet. Similar to the conventional structure, the synthetic securitisation issues securities, e.g. credit-linked notes or credit default swaps, with prices and values that are linked to other underlying securities. Through bilateral credit derivatives, the Protection Buyer is able to manage his exposure to credit risk by separating and transferring the credit risk of specific underlying assets to third parties, without transferring the assets themselves.

The legal risks of synthetic securitisation are somewhat different from the legal risks of conventional securitisation. As conventional securitisation is based on the idea of legally transferring a number of specific assets from the Originators balance sheet, a majority of all the legal risks associated with this procedure will have its origin in the establishment of a clean break and a legal separation of the assets. The synthetic securitisation replicates some of the most important economic effects of the conventional securitisation, but without transferring the underlying assets. Instead, the synthetic securitisations make use of contractual credit derivatives in a series of complicated transactions. In choosing the synthetic structure, the initiator can therefore avoid several legal issues arising out of the separation of the assets, but at the same time, he faces new legal risks that are specific to the synthetic securitisation.

Insufficient documentation, unenforceable derivative agreements and ambiguous definitions are all legal risks that are associated with synthetic securitisation. Furthermore, credit derivatives are a relatively recent contribution to the market of financial instruments, and the lack of legal precedents and case law may cause legal uncertainty. The vast number of variations possible when structuring a synthetic securitisation makes it impossible to cover all the legal issues involved in this procedure and the key issues to be considered will ultimately depend on the context of the particular transaction. This chapter will therefore primarily focus on the most common structures that have already been used in former transactions and aims to isolate some of the most evident problems.

### **6.1 Credit Events**

The process of determining and defining the credit events that will trigger the Protection Seller's contingent payment is often flexible and determined by negotiation between the counterparties. To avoid legal uncertainty it is however crucial to define the credit events as unambiguously and

objectively as possible. The Protection Buyer can only achieve the necessary capital relief<sup>154</sup> if it can be shown that the credit risk of the underlying assets has been properly transferred to the Protection Seller. Should, for example, the definitions of the credit events be to indefinite or restrictive, or should strict materiality thresholds exist, the credit protection may not be recognised when applying for capital relief.<sup>155</sup>

Since 1991, the International Swap- and Derivatives Association (ISDA) has published a standardized letter confirmation that allows parties to transact credit swaps under the ISDA master agreement. This enables the parties to specify the precise terms of the transaction from a number of pre-defined alternatives. In 2003, ISDA published its “ISDA Credit Derivatives Definition” (the ISDA definitions) which complement their publication with the same title from 1999. The publication serves as an improvement of the definitions of credit default swaps, total return swaps and credit-linked notes. These definitions include the specification of six different credit events: failure to pay, restructuring, bankruptcy, obligation acceleration, obligation default and repudiation/moratorium. *Failure to pay* is consistent with what rating agencies title “default” and includes for example any missed or delayed disbursement of interest and/or principal. *Obligation Acceleration* includes situations where an obligation becomes due and payable before it would otherwise have been due and payable, as a result of the occurrence of a default. This means that the option to trigger an Obligation Acceleration credit event can be fully at the lender’s discretion. Moody’s rating agency has furthermore criticized the definition of this credit event to overlap with other credit events, since any defaults under the definition are already captured by Failure to Pay-, Bankruptcy- or Restructuring credit events. *Obligation default* includes all defaults other than failure to make any required payment, and because of its extreme broadness, it has had a limited usage in the credit derivatives market. *Repudiation/Moratorium* is used primarily to address actions taken by sovereign borrowers and includes situations where governmental authorities challenge the validity of the Reference Obligations. Rating agencies<sup>156</sup> have been concerned that ambiguity in the ISDA definitions could cause credit events to be triggered by the dispute over a particular obligation, which actually does not lead to a failure to pay.<sup>157</sup>

Of all the credit events, *Restructuring* is the one causing the most ambiguity and uncertainty in the credit derivatives market.<sup>158</sup> Typically, a restructuring of a debt occurs when a company suffers economic problems and a restructuring of the conditions of the debt is needed to save the business. On the other hand, restructuring of a debt could also be needed for other reasons

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<sup>154</sup> see Section 2.1

<sup>155</sup> *The J.P. Morgan Guide to Credit Derivatives*, page 12-13 and 59

<sup>156</sup> Moody’s rating agency

<sup>157</sup> Pollak, Emily R., *Assessing the Usage and Effect of Credit Derivatives*, page 8-12 and *The J.P. Morgan Guide to Credit Derivatives*, page 12-13

<sup>158</sup> Pollak, Emily R., *Assessing the Usage and Effect of Credit Derivatives*, page 31-32

than saving the business from financial difficulties.<sup>159</sup> In the first ISDA definitions from 1999, there was an evident risk that events, which did not indicate or result from a decline in the credit quality of the Reference Portfolio, could trigger the Restructuring credit event. ISDA therefore tried to address this problem by including an exception in its definitions from 2003 that excludes events “...where such event does not directly or indirectly result from deterioration in the creditworthiness or financial condition of the Reference Entity. Whether or not [this section] will apply depends on the facts and circumstances at the type of the relevant event.” With this exclusion ISDA tried to narrow the definition of Restructuring, but other issues arose. As a result of the changes, the concept of materiality was introduced in the ISDA definitions, as the definitions of credit events no longer solely depended on the objective listing of specific events that would constitute Restructuring. With a material threshold there was a greater risk of ambiguity than with clear objective definitions, and this ambiguity could cause problems when estimating risks in for example regulatory capital relief issues.<sup>160</sup> Furthermore, since it was not always clear whether or not an event resulted from deterioration in the financial condition of the reference entity, additional uncertainty was created. The problems arising from the Restructuring credit event have caused some credit institutions to declare that they will no longer use this definition in their credit derivatives contracts<sup>161</sup>. This position does however sharply contravene with the position of several European banks and bank regulators<sup>162</sup> who requires restructuring as a credit event for regulatory capital relief purposes.<sup>163</sup> In the ISDA definitions of 2003, ISDA published four alternatives regarding the usage of Restructuring<sup>164</sup>. According to these alternatives, the parties could choose between the following:

“ (i) trade without Restructuring; (ii) trade with “full” Restructuring, with no modification to the Deliverable Obligations aspect; (iii) trade with “Modified Restructuring”, as has been market practice in North America since the publication of the Restructuring Supplement in May 2001; or (iv) trade with “Modified Modified Restructuring”, which is a new provision, generally aimed to address issues raised in the European market.”

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<sup>159</sup> Verdier, Pierre-Hugues, *Credit Derivatives and the Sovereign Debt Restructuring Process*, page 52-57

<sup>160</sup> Pollak, Emily R., *Assessing the Usage and Effect of Credit Derivatives*, page 39-40

<sup>161</sup> J.P. Morgan became the first major party to declare that it would not use Restructuring, see Pollak, Emily R., *Assessing the Usage and Effect of Credit Derivatives*, page 34

<sup>162</sup> *Basel Committee on Banking Supervision: Quantitative Impact Study 3, Technical Guidance*, page 32-33

<sup>163</sup> See, for example, the cases of *HBK Master Fund L.P. v. JPMorgan Chase Bank* and *Eternity Global Master Fund L.P. v. Morgan Guaranty Trust Company of New York*

<sup>164</sup> See the ISDA News Release of February 11<sup>th</sup>, 2003, <http://www.isda.org/press/index.html>

When drafting the credit events, the parties thereby have a choice whether to include restructuring or not, but this will still be a choice between the lesser of two evils. If the restructuring credit event *is* included, the bank or credit institution will have a wider protection against credit defaults in reference to the Reference Portfolio. However, like any other clause that take material changes into consideration, the restructuring clause include an element of subjectivity through the material evaluation of the financial situation of the debtor. As already mentioned, the uncertainty created by material clauses can create difficulties when estimating risks and risk transfers in regulatory capital relief issues and risk management. If the restructuring credit event *is not* included, only objective credit events like Failure to pay or Bankruptcy will remain. But if for example the creditworthiness or financial situation of a Reference Entity or Reference Obligation debtor has deteriorated, a Protection Buyer has no other option than trying to force a default through the triggering of the Bankruptcy- or Failure to pay credit events in order to receive credit protection. These credit events do not completely cover all the situations where a Restructuring credit event would be triggered, and the estimated credit protection is therefore narrowed.<sup>165</sup>

## 6.2 Enforceability

One of the key legal concerns regarding credit derivatives is the legal uncertainty regarding enforceability. Because of the lack of legal standards and rulings in this area, there is little guidance of how courts will handle disputes regarding credit derivatives. The only published case, directly approaching the subject of enforceability, is the American case *Ursa Minor Ltd. v. Aon Financial Products*<sup>166</sup>. The case involved a credit default swap where the defendant had sold a swap with a government bond, issued by a government entity of the Philippines, as the Reference Obligation. The only credit event listed in the confirmation of the swap was “Failure to Pay”. When payment was called on the bond, the Philippine government entity refused to pay, claiming that the bond had been unlawfully assigned. A notice of default under the credit default swap was then sent, but the Protection Seller also refused to pay. The Protection Seller argued that the terms of the agreement required delivery of a valid “Reference Obligation” and since the issuer of the bond had declared it invalid, the Protection Seller was not obliged to pay under the swap. However, the Court held in favour of the plaintiff, on the ground that there was a clear waiver in the swap agreement that the defendant should not raise any defences concerning invalidity, illegality or unenforceability of the bond. The court further stated that where parties to an agreement have expressly allocated risks, the judiciary shall not intrude into their contractual relationship. This case,

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<sup>165</sup> Bomfim, Antulio N. *Understanding Credit Derivatives and their Potential to Synthesize Riskless Assets*, page 5-6 and Pollak, Emily R., *Assessing the Usage and Effect of Credit Derivatives*, page 23-32

<sup>166</sup> *Ursa Minor Ltd. v. Aon Financial Products*

being the only case directly addressing the issue of enforceability of credit derivatives, is important as it expressly states that the will of the parties should be accepted when dealing with agreements that allocate risks.<sup>167</sup>

Another issue that has proven problematic when it comes to enforcing credit derivatives is the specification of the Reference Entity. A Reference Entity is defined as “each entity specified as such in the Confirmation and any Successor” in the ISDA definitions<sup>168</sup>. In 2001 and 2002, several disputes arose because of the financial problems of a company that had been used as a Reference Entity under a number of credit default swaps. In two of these disputes<sup>169</sup> the Protection Sellers disagreed that a default had occurred on their respective Reference Entity under the swap. Under the transaction agreement, a subsidiary of a holding company was intended to be the Reference Entity. However, the confirmation specified the holding company as the Reference Entity with obligations in the subsidiary as the Reference Obligations. When the subsidiary filed for bankruptcy, the Protection Seller argued that there was no credit event since the holding company had not filed for bankruptcy. Unfortunately, since both disputes were settled out of court, without any disclosure, the legal uncertainty remains and without further details of the course of events no meaningful answer to the question of the specified reference entities can be made. However, the fact that the disputes initially arose is a good example of the importance of unambiguous definitions in the credit derivatives.<sup>170</sup>

### 6.3 Confidentiality

As in traditional securitisation, the banker’s duty of confidentiality may also cause problems in the synthetic securitisation.<sup>171</sup> The main concern in a synthetic securitisation is the information wanted by the Protection Sellers and the rating agencies to identify the Reference Obligations. Although statutory confidentiality legislation often provides for some exceptions<sup>172</sup> from the confidentiality, these exceptions are not always applicable in synthetic securitisation structure.<sup>173</sup> Where there is a duty of confidentiality, the Protection Buyer is constrained from disclosing the names of the Reference Entities. Many transactions are however structured in such a way that the disclosure of the Reference Entities to the Protection Seller, and the

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<sup>167</sup> Pollak, Emily R., *Assessing the Usage and Effect of Credit Derivatives*, page 5-7

<sup>168</sup> § 2.1

<sup>169</sup> *Swiss Re Financial Products v. XL Insurance Ltd.* and *UBS AG v. Deutsche Bank AG*, both in the High Court of Justice in London.

<sup>170</sup> Pollak, Emily R., *Assessing the Usage and Effect of Credit Derivatives*, page 15-16

<sup>171</sup> For the specific statutory and common law origin of the bankers duty of confidentiality, please see section 5.5

<sup>172</sup> See the Swedish “Kreditupplysningslagen (1973:1173)”, the U.S. Privacy Act of 1933 and the exceptions set out in the U.K. case *Tournier v. Nat'l Provincial and Union Bank of England*

<sup>173</sup> Albrecht, Thomas J., *Corporate Loan Securitisation: Selected Legal and Regulatory Issues*

delivery of information confirming a credit event, is conditional for the payment of the Credit Protection Amount. The parties of securitisation have tried to get round the legal duties of confidentiality in a number of different ways. Through the exclusion of the names of the Reference Entities from the details of the Reference Portfolio or through precisely defined eligibility criteria with which the Reference Obligations/Entities and Reference Portfolio must comply the sensitive information can remain undisclosed. Another method is to trust the Protection Buyer to act as the calculation agent, i.e. the party that determines whether a credit event has occurred, with the Protection Buyer's external auditors, which will have access to all confidential information, as supervisors of the whole transactions. Especially when dealing with non-publicly traded assets, it is common to let the Protection Buyer's auditors or accountants confirm the notice of a credit event. If the Reference Obligations are publicly traded, information supporting the existence of a credit event is often publicly available.<sup>174</sup>

## 6.4 Insurance

Credit derivatives offer the Protection Buyer the possibility to transfer the credit risk of an asset to a third party in return of fixed payments. This concept is not only acknowledged in the credit derivatives market, but also in the Insurance industry. The resemblance between the credit derivative and an insurance contract has caused considerable concerns in the credit derivatives market as to the legal nature of the credit derivative, and then especially the credit default swap. If for example a court would classify the credit default swap as an insurance contract, this could cause serious difficulties and inconvenience for the parties of the derivatives market. The Protection Seller in a synthetic securitisation would have to follow the rules and regulations of an insurance company, and in most jurisdictions apply for authorisation of his insurance businesses. This would be both costly and time consuming and increase the administrative burden of the synthetic securitisation. Furthermore, in for example the U.K. it is a criminal offence to carry out insurance businesses without proper authorisation, and an unauthorised insurance contract can be declared unenforceable.<sup>175</sup>

When distinguishing credit derivatives from insurance contracts, the most important of the principles of the insurance law is the principle of insurable interest in the subject of insurance. The British statutory definition of insurable interest reads<sup>176</sup>:

"a person is interested in adventure where he stands in any legal or equitable relation to the adventure or to any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss, or damage thereto, or by the detention thereof, or may incur liability in respect thereof."

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<sup>174</sup> Uwaifo, Elizabeth, *Europe Securitisation and Structured Finance Guide 2001*, page 6-9

<sup>175</sup> See the U.K. Insurance Company Act of 1982

<sup>176</sup> Section 5 of the Marine Insurance Act

The principle of insurable interest has been one of the cornerstones in lawyers' opinions that the credit default swap in a synthetic securitisation is not the same thing as an insurance contract.<sup>177</sup> The market originally relied on the statement of Robin Potts QC in 1997, that is, not surprisingly, supported and sponsored by ISDA.<sup>178</sup> Potts distinguishes the credit default swap by looking at the underlying principles of an insurance contract and his argumentation generally goes as follows. *The first* key argument is that as the Protection Buyer in a credit default swap is not required to own the assets that are subject to the acclaimed insurance contract in order to be entitled to the related payment, he has no absolute insurable interest and there can be no insurance contract. For that reason, a document that expressly states that there is no requirement for the Reference Obligation to be held by the Protection Buyer is now a standard document in any dealing with credit derivatives.<sup>179</sup> *The second* key argument is that the payment that is to be made in the case of a credit event in reference to Reference Obligation does not necessarily correspond to a loss, since the Protection Buyer may not own the particular asset or is otherwise not affected by the credit event. And even if he does own the asset, the loss may not be immediate, as the Protection Buyer can realize his loss at a later stage. If, for example, the settlement amount in case of a credit event is set to be calculated by reference to the diminution of market value of the Reference Obligation, there is no duty for the Protection Buyer to sell the Reference Obligation at that market value at that time. These arguments have made the trading with credit default swaps in synthetic securitisation possible, without interference with regulations and compulsory registration that otherwise apply to insurance companies. However, recent developments in the European synthetic securitisation market, to calculate the Settlement Amount on actual loss of the Protection Buyer, have again taken the credit default swap dangerously close to the insurance contract.<sup>180</sup>

In, for example, Deutsche Bank's (DB) synthetic securitisation "Cast 1999-1" the settlement amount of the credit default swap was calculated with reference to the actual loss suffered from a defaulted reference obligation. By doing so, and by not e.g. using a fixed amount, DB could get the same risk weighting and rating on the corporate loans as the Protection Seller, an OECD bank. The settlement amount was therefore calculated based on the difference between the face value of the defaulted assets and the amount actually recovered by the DB in respect of the defaulted assets. Ignoring the thresholds involved, this meant that DB was guaranteed to be held unharmed in case of a credit event, but it also raised some other concerns, which could constitute to even bigger risks.<sup>181</sup>

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<sup>177</sup> Paul Forrester, *Synthetic Resecuritizations: A Step Too Far?*, page 3

<sup>178</sup> Pollak, Emily R., *Assessing the Usage and Effect of Credit Derivatives*, page 22

<sup>179</sup> Uwaifo, Elizabeth, *Europe Securitisation and Structured Finance Guide 2001*, page 6

<sup>180</sup> Paul Forrester, *Synthetic Resecuritizations: A Step Too Far?*, page 3

<sup>181</sup> Uwaifo, Elizabeth, *Europe Securitisation and Structured Finance Guide 2001*, page 6

If the settlement amount is to be calculated by reference to the Protection Buyer's actual loss, the question arises how this loss could be determined without the Protection Buyer being the owner, holder or involved in the liquidation (any insurable interest) of the Reference Obligation. With a substance over form reasoning, the main argument why the credit default swap is not an insurance contract, i.e. as the Protection Buyer is not required to own or hold the asset he does not suffer any loss and have no insurable interest, can therefore be questioned. What first distinguished the credit default swap from the insurance contract was that the Protection Seller was obliged to pay the Protection Buyer on the occurrence of the credit event, whether or not the Protection Buyer had actually suffered any loss.<sup>182</sup> With the calculations based on the Protection Buyer's actual loss, there is however an understanding, may it be indirectly, that the Protection Buyer must hold the insured assets, in order to determine the correct settlement amount. If, for example, the Reference Portfolio is held by someone else than the Protection Buyer, the settlement amount can not be determined with the accuracy needed, or even worse, the Protection Seller may refuse to pay any amount at all, since the Protection Buyer has no loss to present.<sup>183</sup>

The question of whether the new development in the European synthetic securitisation market has jeopardized the legal status of the credit default swap has not yet been tried in court. The market therefore still relies on the traditional argument that separates credit derivatives from insurance contracts.

## 6.5 Impact of Basel II

Since the first publication of the consultative documents from the Basel Committee, proposing new regulatory framework for capital requirements, interested parties<sup>184</sup> have claimed that the regulations are discriminatory to synthetic securitisation. It is not so much a concern that the new Basel II will be disadvantageous for synthetic securitisation in comparison with Basel I, but rather that the new regulatory framework will discriminate the synthetic structure in favour of the conventional securitisation. The complaints, mostly coming from European banks and European- and American securitisation and derivatives associations, address a number of issues in the Basel regulations that could restrain and discriminate the market of synthetic securitisation in relation to conventional securitisation. When developing the new Basel Accord, the rules concerning conventional- and synthetic securitisation have been dealt with by two separate Basel working groups, resulting in sometimes inconsistent outcomes. One of the biggest concerns is a standardised approach to the whole synthetic securitisation structure. Complainants have claimed that the Basel working

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<sup>182</sup> Ross, Maria, *Credit Derivatives and Insurance - a World Apart?*

<sup>183</sup> Uwaifo, Elizabeth, *Europe Securitisation and Structured Finance Guide 2001*, page 7

<sup>184</sup> See ISDA's comment paper on the New Basel Capital Accord from December 2001

group has assumed a typical synthetic securitisation structure when drafting the new regulations, whilst in reality no such typical structure exists.<sup>185</sup> The protection buyer must, to a higher degree, be able to free up regulatory capital consistent with the actual risk transferred, and not according to the standardised typical structures that the Basel Committee has adopted.

For example, according to the new Basel Accord, the synthetic securitisation should be treated in the same way as a cash variety when assessing risk. This could however result in a discriminatory treatment, as synthetic securitisations often are less risky than a mere cash transaction. The super senior tranche of a synthetic securitisation structure is often guaranteed by a bank from an OECD jurisdiction. The structure therefore offers two options of repayment: the company that borrowed the money and, furthermore, the payment obligation by the guarantor. As the Basel regulations only base their risk weighting on the guarantor's credit rating, the repayment obligation from the company obligor is not taken into account in the calculation of risks. Since the probability of both parties defaulting their obligations is very remote, critics claim that the risk weighting should be calculated in a more favourable way than the Basel regulations impose.<sup>186</sup>

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<sup>185</sup> Ibid.

<sup>186</sup> Westlake, Melvyn, *Drive for bigger Basel II securitisation changes*

# 7 Comparative analysis

The complex nature and the numerous transactions involved in both conventional- and synthetic securitisation structures are bound to cause legal concern and uncertainty. Although the structures and purposes of these different arrangements may look the same, the nature of their respective legal issues often differs to a great extent. This chapter will compare the origin of the different legal risks involved in conventional- and synthetic securitisation. It will further evaluate the impact of different legal systems on the structure and efficiency of the two different securitisation arrangements.

## 7.1 Advantages and Disadvantages

When comparing advantages and disadvantages of the two different structures, one must have in mind that securitisation is first and foremost a question of economic preferences, and these will ultimately prevail when choosing between the different structures. Nevertheless, legal risks might also be translated into costs when calculating the economic benefits of a transaction, as the risk of e.g. unenforceable documents, automatic stay in a bankruptcy and reclassification can be very expensive. Seen strictly from a legal aspect, the different features and legal issues of conventional- and synthetic securitisation are very diverse. This part will only focus on the comparison of the legal risks, whilst economic influences will be dealt with later in this analysis.

### 7.1.1 The Underlying Asset

The most obvious difference between the conventional and synthetic securitisation is the legal handling of the underlying assets. Whilst the conventional structure uses an off-balance sheet treatment of the receivables, the synthetic on-balance sheet structure may avoid all the likely problems arising from a legal separation of the assets. Credit derivatives enable the bank or credit institution to achieve a required economic result by imitating the effects of an actual transfer. Seen from a legal point of view, this is a major advantage of the synthetic structure, as a majority of the legal issues involved in a conventional securitisation have their origin in the establishment of a true sale of the assets and a bankruptcy remoteness of the SPV.

In a *conventional securitisation*, the Originator, apart from perfecting the sale of the assets, through an enforceable contract, physical delivery and/or notification, must also make sure that his influence over the underlying assets is kept to a minimum. Any relation to the governance, ownership or the right of disposal of the assets may result in unenforceable security

interests or a reclassification into a secured loan. The real dilemma for the Originator is the fact that such relations sometimes may achieve positive economic results. To get a good credit rating on the asset-backed notes, a credit enhancement consisting of a guarantee from the Originator may be the only option. In addition, the fact that it is common for the Originator to invest in a small portion of the junior class asset-backed notes as a credit enhancement, further add to the legal uncertainty regarding the bankruptcy remoteness of the SPV and the question of asset segregation.

The *synthetic securitisation*, on the other hand, only transfers the credit risk of the assets, making a separation unnecessary. The investors of a synthetic structure do not invest in the future proceeds of separated underlying assets, but rather in the probability that a credit default will not occur. Although the underlying assets are not separated, the credit risk and the risk weighting of the issued notes can still be separated from the initiator. In a structure using an SPV, the investors principal of the credit-linked notes are often secured in the investment of highly liquid government bonds and other credit enhancements. This enables a Protection Buyer with a low credit rating to isolate the credit risk of the assets and get a higher credit rating than his own on the credit-linked notes, without ever involving an asset transfer or a true sale. A Protection Buyer in a non-SPV structure is often a party with a good credit rating, but he may nevertheless issue senior class notes with a higher credit rating than his own through collateralisation and credit enhancements. The unfunded credit default swap in a synthetic structure is often made with a credit institution in an OECD member state with a good credit rating of its own and the credit risk of the Reference Portfolio can therefore be isolated and transferred with a low risk weighting as a result.

Hence, when the conventional securitisation relocates the risk of the underlying assets by actual transfer and legal isolation, the synthetic structure isolates and relocates the credit risk by documentation through credit derivatives.

### **7.1.2 Governance**

In order to achieve a legal separation and a clean break of the assets, the creators of a conventional securitisation put a lot of effort to make sure that the SPV and its assets are governed by an independent party. An indirect control of the assets through, for example, an SPV board of directors where a majority consists of Originator employees, would most likely render the whole legal separation of the assets unenforceable.

The structure of the *conventional securitisation* requires the governance of the SPV to be stable, neutral and static, as the main function of the SPV is to own and preserve the value of its assets. Neither the investors, nor the Originator, expect or require any high profits through risky investments, as the investor's interest are often fixed and the Originator, although a residual interest in the assets might exist, does not expect a risk weighted interest on

the assets transferred. The independent governance may be achieved in a number of ways. An SPV structured as a trust, a corporation with independent directors and a trustee representing the investors or a foundation are all examples of entities that have been used in the past. The key to avoid legal uncertainty is to find a governance structure that legally separates the assets, ensures stability, protects the investors from insolvency of both the Originator and the legal owner of the assets, and at the same time imposes an obligation on the managers to always look to the interests of the investing parties. The common law commercial trust, with a trustee as the legal owner of the assets, is the entity that comes closest in fulfilling all these features. However, trust-like entities in civil law jurisdictions have also shown themselves functional, even if these structures generally lack some of the basic protections to the investors that comes with the common law trust. Such features are for example the trustee's fiduciary and impartiality duties and the separation of the legal ownership of the assets between the SPV and the trustee.

The management of the assets in a *synthetic securitisation* is less problematic. Again, the synthetic structure does not require a legal separation of the Reference Pool with an independent governance of the Reference Obligations. It is true that a synthetic securitisation using an SPV needs to maintain the bankruptcy remoteness of the SPV, and therefore it also needs an independent management. However, the SPV in a synthetic securitisation does not need to separate any underlying assets from the Protection Buyer. Instead, it merely holds the cash received from the issued notes in order to return it to the investors if no credit event occurs or, alternatively, to the Protection Buyer if one does. These assets of the SPV are often held by a trustee. But unlike in the conventional securitisation, where a trustee is used both to ensure a clean break of the assets from the Originator, and to hold the investments from the notes issued by the SPV, the trustee in the synthetic structure only assumes the latter of these two roles. The fiduciary duty, the duty of impartiality and the insolvency remote features of the trustee are efficient virtues that help maintaining the value of the assets of the bankruptcy remote SPV, insulating investors and the Protection Buyer from delays and default when payment is required. However, the trustee in a synthetic securitisation is not an indispensable tool to ensure the legal stability of the whole securitisation structure. It is merely a safeguard for a just treatment among the investors and an instrument to get a good risk weighting on the payment obligations to both the Protection Buyer and the investors.

In a synthetic structure not using an SPV, the Protection Seller's credit protection obligation is not secured by any separated assets in a bankruptcy remote SPV. When issuing credit-linked notes directly to investors, the only way to achieve a degree of comfort that the note holders are going to be good for the money is to accept only fully funded issues. The investors on the other hand, secure their repayment of the principal through the binding derivative contract from the Protection Buyer, which is often a bank with a high credit rating, in combination with some sort of collateral. When using a

credit default swap, the protection obligation is secured by an OECD member state bank with a low risk weighting. Consequently, the only asset governance relevant to the legal stability of the structure is the management of the Reference Pool that can be handled by the Protection Buyer with satisfactory results for all parties. To summarise, as the synthetic securitisation structure is not based on a true sale and a separation of legal ownership of the underlying assets, the governance of the assets involved is not fundamental to the legal foundation of the structure in the same extent as in conventional securitisation.

### **7.1.3 Regulatory Foundation**

In order to obtain legal certainty it is crucial to have a predictable regulatory foundation and established standards. As the synthetic securitisation is a relatively new financial procedure, the conventional securitisation has a big advantage with its established market and special statutory legislation. Jurisdictions all over the world have tried to overcome the legal uncertainties of the securitisation structure by, for example, enacting special laws for securitisation, trusts, SPVs and the true sale of receivables. Government authorities have furthermore issued specific regulations and guidelines of what constitutes a legal separation and a clean break of the assets between the Originator and the SPV. Ambiguities regarding what is considered acceptable relations between the parties in order not to reclassify the transaction as a secured loan and to fully affect a risk transfer have thereby been removed, even though financial incentives may tempt the parties to compromise these often very clear rules. Laws regarding trusts, trust-like institutions and SPVs in civil law countries have facilitated the means to set up bankruptcy remote entities with relatively safe and static governance. Countries like Italy and Spain have even issued special securitisation laws, in order to promote the use of conventional securitisation.

The synthetic securitisation on the other hand, suffers from the effects of an insufficient regulatory structure. The two major authorities on rules and guidelines that affect synthetic securitisation and credit derivatives are ISDA, with their master agreement and credit derivatives definitions, and the Basel Committee, with their rules on risk weighting and capital adequacy. With the ISDA Master Agreement and the ISDA Credit Derivatives Definitions, progress has been made to standardize the credit derivatives market. However, these regulations are only optional guidelines and examples, not incorporated in any statutory legislation. Critics have furthermore expressed their concerns that the ISDA definitions may create uncertainties because of material thresholds and other ambiguities in the definitions of credit events. The new Basel II, regarding capital adequacy, has also been subject to criticism from interested parties, as complaints of synthetic securitisation discrimination and an excessive standardised approach to the complex and shifting synthetic structure have been raised. The lack of legal standards and court rulings, especially in the civil law

jurisdictions, further add to the legal uncertainty of synthetic securitisation and credit derivatives, and the insufficient regulatory framework as well as the absence of relevant precedents today constitute the biggest legal risk in synthetic securitisation.

### 7.1.4 Customer Relations

When a bank decides whether to securitize its assets through a *conventional securitisation* or not, it has to balance the benefits of retaining its business relationship with its obligors against the cost savings associated with the transaction. The bank must also balance its extent of engagement and the relationship with the customer against the risk of jeopardising the true sale criteria and the clean break of the assets transferred. Even though the bank can still act as a servicer in the securitisation transactions, and thus keep its administrative relations with the obligors, the commercial lender relationship of the bank will be legally transferred to the SPV. In order to establish a good customer relationship it is often important for a bank to respond and be flexible to the shifting needs of the customer. Local corporate borrowers, with a strong connection to their bank, might for example react negatively if they, due to financial difficulties, have to renegotiate their loans and find out that this is now done with an SPV, often located abroad, with no interest in the future of the corporate borrower. Furthermore, an Originator who wants to avoid the disturbance of customer relations needs to consider not only the commercial perspective, but also the legal duties, such as the banker's duty of confidentiality, that he owes to the customers. Both English and American law offers the possibility to transfer assets without informing the borrower of the assignment: the U.K. equitable assignment requires no debtor notification, and the U.S. filing of a UCC financing statement perfects a sale of receivables without any individual debtor notifications. However, even if this allow the common law Originator to leave the borrower unaware of the transaction, the fact that the equitable- or legal title of the assets has been transferred can damage customer relations and cause troubles when, for example, re-negotiating the loan terms.

The *synthetic securitisation* offers the banks the possibility to transfer the credit risk without endangering the valuable bank-customer relationship. With the assets still on the Protection Buyer's balance sheet, the relationship between the lender and the borrower does not have to change as a necessary result of the transaction. Although not as intrusive on the customer relation as a legal transfer of the assets in a conventional securitisation, the effects of the synthetic securitisation might however be noticeable to the borrower. If, for example, the borrower requests re-negotiations of the loan terms, problems may arise as re-negotiations or restructuring of debt could be credit events that trigger a credit default under the credit derivative. A Protection Buyer that does not intend to trigger such credit defaults then have to negotiate with the borrower and try to find financial alternatives to the restructuring of the debt that is included in the Reference Obligations.

Furthermore, the Protection Buyer can also face difficulties in certain situations due to the banker's duty of confidentiality. As the parties of the synthetic structure can request access to confidential information about the Reference Pool, the Protection Buyer must find means to deliver such information without endangering its statutory duties to the customer. As explained in Section 6.3, this is often solved by, for example, excluding the names of the Reference Entities from the details of the Reference Portfolio.

## 7.1.5 Documentation

The complex nature of the different transactions required to set up a *conventional securitisation* necessitates a very complicated and detailed documentation. The Sale Agreement of the assets, the Administration Agreement of the SPV, the Underwriting Agreement between the SPV and the party responsible for raising the capital from the investors, the Declaration of Trust relating to the shares of the SPV and the Security Trust Deed, which governs the assignment of the underlying assets to the trustee, are only a few examples of the documentation needed to set up a conventional securitisation. Each and every one of these documents have to be scrutinised and thoroughly prepared in order to avoid legal uncertainties, a process which can be both time consuming and costly.

The *synthetic securitisation* does not require the same quantity of documentation as it involves less parties and transactions. However, an ambiguous and badly drafted contract or definition has a greater negative impact on the legal structure of the synthetic structure than on the conventional. The manner in which the existing contracts of the synthetic structure are drafted is what actually determines the structures legal certainty, as the mere accuracy of the contract is the source of a majority of the legal issues of the synthetic securitisation. As the derivative contract derives its value from an underlying asset, it has no real value of its own, but is completely dependent on the ability of the contract to determine how its value should be decided in respect of the assets. For example, the price of the credit derivative is driven by the credit risk of the Reference Portfolio. In order to get an accurate price and an enforceable contract, the Reference Portfolio must be sufficiently defined in the contract. Furthermore, the payment of the credit protection amount is completely dependent on well-defined and unambiguous credit events that can leave no room for subjective decisions whether a credit default has occurred or not. The danger of, for example, material thresholds in the definitions of the credit events and a step back from objectivity, is therefore not to be underestimated, but rather treated with concern, as it can cause legal uncertainty and render the whole risk transfer ineffective.

Predictability and certainty are of course also important features of the contracts of the conventional securitisation, but the documentation of the conventional structure is to a large extent supported by statutory rules and

precedents. Even though it is important to arrange the Sale Agreement of the assets so that the ownership and the right of disposition is actually transferred, legal systems will support a valid transfer if it is perfected through a valid contract, notification of the obligor or the physical delivery of the assets. And even though it is important to properly define the duties of the Servicer and the Administrator in the Administration Agreement with the SPV, there are lucid regulations and guidelines concerning acceptable relations between the Originator and the SPV in order to affect a clean break. The biggest advantage of the derivative contract and the synthetic securitisation, its flexibility, is therefore also its biggest disadvantage, since the enforceability and effectiveness of the synthetic structure is very much the responsibility of the drafters of the credit derivative contracts.

## **7.2 Economic Considerations**

Although this paper focuses on the legal issues of the conventional- and synthetic securitisation, it is also important to mention the economic characteristics of the two different structures. This part will briefly examine some of the economic features that can affect the choice of the Originator/Protection Buyer (the Initiator) when choosing between arranging a conventional- or synthetic securitisation.

### **7.2.1 Securitisation as a Source of Funding**

When defining the purposes of a securitisation, these can be divided into two categories. On one hand, securitisation is an effective tool for balance-sheet-, capital ratio- and risk management, i.e. features that concern the mere configuration and organization of the initiators' financial structure. On the other hand, a securitisation can be arranged primarily to attain funding at advantageous rates and maturities. If the main objective with the securitisation is to generate a new founding source, conventional securitisation is preferable to the synthetic alternative. Especially for companies with a low credit rating or with bad connections to the capital market, conventional securitisation can be used to raise funds at conditions otherwise unattainable. The variation in different investor risks and returns, achieved by the division of the asset-backed securities issued by the SPV into different classes and tranches, can attract new investors that would otherwise not invest in the Originator's business. Furthermore, the conventional securitisation offers the Originator the means to exchange future incomes from the receivables against a cash payment at the deployment date; a fact that could be vital to, for example, big acquisitions and investment projects. The typical synthetic securitisation structure is however not favourable when attracting new funding. As most synthetic structures are only partially funded, a synthetic arrangement will result in a collection of a relatively small amount of cash compared with the conventional structure. The credit-linked notes, which usually are fully funded, only constitute 10-15% of the total credit risk transfer in the

majority of the synthetic securitisations that have been arranged, whilst the unfunded credit default swap comprises the highest portion of credit protection. Consequently, companies and other business entities that search for cheap funding are not common initiators of synthetic securitisations, whilst banks and credit institutions, with no shortage of funds or alternative funding options, arrange the majority of all synthetic structures.

## 7.2.2 Balance sheet- and Capital Ratio Characteristics

When the Originator in a conventional securitisation has legally separated the assets and a clean break is achieved, the assets can be removed from the Originator's balance sheet. This can be favourable in a number of situations where the Originator wants to improve the appearance of his accounting and capital- and leverage ratios. Ratios are tools for quantitative analyses of the information in a company's or credit institution's financial statements and are used to simplify the assessment and evaluation of the performance of the entity.<sup>187</sup> If, for example, the transferred receivables are replaced in the balance sheet by the cash proceeds that are generated from securitising the assets, ratios like the *Working Capital Ratio*<sup>188</sup> or the *Return on Equity*<sup>189</sup> can be improved. The synthetic securitisation however, will have no impact on the size or appearance of the balance sheet. Although a synthetic securitisation may have a positive effect on, for example, the Return on Equity, due to the cash released from the regulatory capital requirements, the balance sheet and most ratios will be left unaffected by a synthetic securitisation. In situations where the initiator wants to leave the balance sheet unchanged, and only transfer the credit risk of the assets, the synthetic structure is the better alternative. But where management of balance sheet characteristics is one of the main priorities, the conventional model is the only option.

## 7.2.3 Regulatory Capital Relief

Banks, primarily in the U.S. and the U.K., frequently use the conventional securitisation in order to avoid regulatory capital requirements. It is an effective instrument when used to separate credit risks as the true sale legally transfers the assets, and all the risks associated with them, from the Originator to the SPV. But because the amount of credit exposure that can be transferred in the conventional securitisation is restricted to the investor's capacity to invest in the assets, the synthetic structure offers a sometimes

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<sup>187</sup> See Chapter 3 and *supra* text accompanying note 28.

<sup>188</sup> Working Capital Ratio is used as an indication whether a company has enough short-term assets to cover its immediate liabilities. It is calculated by dividing Current Assets with Current Liabilities

<sup>189</sup> Return on Equity is a measurement of an entity's profitability that reveals how much profit a company generates with the money shareholders have invested. It is calculated by dividing the Net Income with the Shareholder's Equity.

more efficient and cheap alternative to transfer credit risk. In the conventional structure, the transfer of credit exposure requires the issuance of notes. The notes often have to be credit enhanced in order to get a good credit rating and the investors will furthermore insist on a small spread above the reference rate in order to make a profit. In the synthetic securitisation, only a small part of the credit exposure is transferred through funded credit-linked notes, whilst the unfunded credit default swap assumes the biggest portion of the credit exposure. As the funded part of the credit risk transfer in a synthetic structure only constitutes 10-15% of the credit protection amount, only a small part of the protection amount will be dependent on the investor's capacity to invest in the credit-linked notes. The majority of credit protection, generally 85-90%, will be provided by the credit-default swap counterparty through an unfunded credit default swap. And because most of the Protection Sellers' factual risk of losing their investments is taken up by junior- and mezzanine credit-linked note holders, the swap counterparty will only request a relatively small fee for its protection. The synthetic structure thereby allows for a relatively cheap transfer of credit exposure, and furthermore, it enables a transfer of credit exposure to an amount and quantity that would not have been possible with a fully funded issuing to the capital market. The combination of the access to capital markets, private investors and the inter-bank markets thereby makes the synthetic securitisation advantageous in relation to the conventional structure when transferring credit risk.

#### **7.2.4 Costs**

A securitisation will only be deployed if the profits of the procedure exceed the transaction costs. The cost of setting up a conventional securitisation may vary significantly depending on in which jurisdiction it is arranged. For example, a conventional securitisation arranged in Spain, where a special Securitisation Act has been passed, would generally have lower transaction costs than a conventional securitisation placed in Sweden or Germany, where no such extensive steps have been taken to incorporate securitisation in the statutory law. However, disregarding the choice of jurisdiction, the conventional securitisation is generally an expensive procedure to arrange. As the cost of setting up an SPV, arranging credit enhancements, accounting- and legal fees and other transaction costs can be very extensive, the conventional securitisation will only be profitable if the value and the profits of the assets securitised are relatively high. The synthetic securitisation is normally a less expensive alternative to conventional securitisation. Besides the cheaper regulatory relief discussed above, the synthetic structure is less complicated, easier to set up and therefore normally has a lower total implementation cost. The avoidance of a true sale of the assets saves costs of, for example, accounting, foreign legal fees when the asset pool consists of assets from different jurisdictions or other costs associated with the establishment of a sale. Furthermore, the initiators may rely on economic cost and efficiency, rather than bankruptcy remoteness needs, when choosing between a structure that uses an SPV or not. As the

arrangement of an SPV can be quite expensive, the option to structure a securitisation without an SPV is a big advantage of the synthetic structure when comparing costs.

## **7.3 Legal Conditions for Securitisation in Civil- and Common Law Jurisdictions**

This final chapter of the paper will evaluate and analyse the differences in the legal conditions of conventional- and synthetic securitisation between civil- and common law jurisdictions. By identifying the differences in the legal climate of the two different legal systems, this chapter will examine the legal influences that affect the growth and progress of the securitisation market.

### **7.3.1 Conventional Securitisation**

The fact that conventional securitisation has not shared the same success in continental Europe compared primarily with the U.S., but also the U.K., can be explained by a number of different factors. Generally, it is fair to say that the U.S. has a better economic foundation when it comes to securitisation than other jurisdictions, with a strong tradition and acceptance of asset-backed securities and an efficient asset transfer- and mortgage registration system. Legally, there are also several other factors that are advantageous in common law jurisdictions:

*Firstly*, the U.S. perfection of a true sale of receivables and a security interest is achieved through the registration and filing of a UCC financing statement. Once registered and made public, the sale is legally binding to all parties, without any requirements of physical delivery or notification. European jurisdictions, the U.K. included<sup>190</sup>, have a more complicated system that requires either a physical delivery or a notification of the transfer to the debtor, in order to perfect a sale and a security interest. Notification requirements may be especially burdensome to the Originator in a securitisation, if the Originator, for example, wants to securitize a number of credit card debts with multiple debtors. The U.S. registration system significantly simplifies the securitisation procedure, as the Originator can reduce legal uncertainties regarding the security interest of the asset by a single filing of a financial statement, instead of notifying several parties about the transaction.

The U.S. perfection system is characterised by a struggle for efficiency of the financial system as a whole and a simplified procedure, features that

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<sup>190</sup> Although the transfer of British registered instruments can be perfected through registration, the British legal system lack the simplicity and conformity of the American UCC filing system, which is applicable for the perfection of all receivables and promissory notes.

benefit the parties of securitisation in terms of legal certainty and a reduction of transaction costs. European jurisdictions (still including the U.K.) have a stronger tendency than the U.S. to be more conservative, and to rely on judicial traditions and theories, in their solutions of legal matters. But legal instruments and practices, which separately are effective and well adapted to their traditional purpose, can often create uncertainty and inefficiency when placed in a new context. The requirement of debtor notification in securitisation is a good example of this inefficiency, as securitisation challenges the traditional bank-borrower relationship and requires a simplified procedure to achieve profitable results. The biggest advantage in the U.S. position on legal perfection of a sale is therefore its focus on results, rather than the focus on traditional- and academic judicial theories of debtor notification and possession of the assets, practiced in European jurisdictions.

*Secondly*, as the SPV for a number of years has played an important part in the financial world and the commercial law of both the U.S. and the U.K., an acceptance and practice has developed which allows for bankruptcy remoteness in relation to the original creators of the entity. Without any specific legislation for the creation of special SPVs, these entities are incorporated like any other corporation, limited liability company or trust. Civil law jurisdictions have also realised the value of bankruptcy remote entities when isolating financial risks, and have accepted the SPV, either directly through special legislation, or indirectly, by the mere recognition of its existence. Securitisation has played an important role in the acceptance of SPVs in civil law jurisdictions, as the SPV is an indispensable component in order to separate the assets in a securitisation structure. However, although the actual structure and bankruptcy remoteness of the SPV are now established, the businesses conducted by the SPV have been subject to some concern. In securitisation, the SPV must issue asset-backed notes to capital investors in order to finance the purchase of its assets. Regulatory framework, in for example Sweden, however generally requires that such financial businesses necessitate a licence, and more importantly, subject the SPV to regulatory capital requirements. In order to facilitate for a Swedish securitisation market, amendments to these licence requirements were recently enacted, exempting SPVs from regulatory capital requirements in certain situations. But in order not to violate the EU legislation that regulates credit institutions, Swedish legislators chose to implement conditions of a limited number of acquisitions accepted by the SPV in order to be included in the exemptions. The Swedish regulations of the financial businesses of the SPV are therefore a compromise between efficiency and an ambition to control the operations of credit institutions.

American and British laws also have licensing or registration requirements for entities conducting lending activities in their jurisdictions, but an SPV in a securitisation structure will not be subject to regulatory capital requirements. British law is of course also subject the same EU legislation as Swedish law, but British legislators have considered their control of credit institutions sufficient and not contradictory with any directives from

the EU. The U.S. and the U.K. regulatory capital requirements do not focus on the credit institution market as a whole, but rather on those institutions that raise their funds through deposits from the public. American- and British regulatory capital requirements are concentrated on those traditional institutions where the investor- and depositor protection is really needed, whilst institutions like the SPV in a securitisation structure are exempted from such requirements. The rationale is simple: the only parties that might need protection through a regulatory capital requirement in a securitisation SPV are the investors of the notes issued. But the SPV investors base their decisions on whether to invest in the notes or not on the risks associated with the underlying assets and the various credit enhancements of the SPV. Rating agencies estimate the risks and the more risk the investors are prepared to accept, the higher yield will they get on their investment. As opposed to the traditional bank-depositor relationship, where the customer expects a small periodic payment in return for his deposit, the investor of asset-backed notes expects payments based on the actual performance of the underlying assets. Non-performance of the underlying assets is therefore included in the investors' risk calculations and a regulatory liquid cash reserve of the SPV to cover performance defaults would contravene with the actual purpose of the issuing of asset-backed notes.

Again, the underlying principle behind the U.S.-, but also the U.K.-, legislation concerning SPV licence requirements is the struggle for effective and desirable results, attuned and compatible with the modern finance world, rather than the more conservative theory of investor and depositor protection for all credit institutions.

*Thirdly*, as an instrument to ensure the independent governance- and bankruptcy remoteness of the SPV, a legal separation and a clean break of the assets and an equal treatment of the beneficiaries of the SPV, common law jurisdictions use trust law. Trusts are used either as an SPV, or as the holder of the shares of a corporate SPV, and a trustee is appointed to represent the investors and to hold and separate the cash flows. As shown above, civil law jurisdictions do not have an adequate equivalent to trusts, but are in securitisation referred to use existing entities in their respective jurisdictions that share not all but some of the virtues of the common law trust. Although some jurisdictions have tried to implement trust law in their own legal systems, such attempts often fail, as the common law trust is not simply a separated instrument to administer and manage capital and property. With its history, starting in the 11<sup>th</sup> century, the common law trust has been deeply integrated in the common law legal systems. For example, the separation of legal property interests, typical for English common law, into equitable- and legal ownership, originally produced the means for a flexible and insolvency remote governance of the trust. The dual ownership of the trust assets helped evolving the limited liability of the trust relationship, the inability of the trustee's personal creditors to claim against the assets, the fiduciary duties of the trustee and a very efficient governance of the trust. Today, these characteristics of the trust relationship have effects on both American- and British Property-, Insolvency-, Contract- and

Company Law. The main disadvantage for civil law countries is the fact that the complex trust often has an indispensable role in the dominating Anglo-American-based modern financial structures. Consequently, in order for civil law countries to keep their transactions on a domestic level, they have two options when circumventing the legal issues created by the absence of a general trust law. They can either use an existing entity or legal instrument that reproduce some of the results created by a trust, or, create new specific entities, with special legislation, that solve the trust issues on a case-by-case basis. None of these procedures is however preferable, as the process is bound to be complicated, inefficient and inconsistent.

### **7.3.2 Synthetic Securitisation**

The legal conditions of synthetic securitisation are somewhat different from those of conventional securitisation. As the transactions in a synthetic securitisation are primarily founded on bilateral derivative contracts, the success of the structure is first and foremost dependent on the documentation and structure of the separate transactions and, to some extent, national and international Contract Law. With no true sale of the assets and the possibility to set-up an efficient structure without including an SPV, the synthetic securitisation emancipates itself from legal efficiency-barriers and uncertainties created by, for example, national Property- and Insolvency Law and regulatory licence requirements. Although the synthetic securitisation suffers from several legal uncertainties, these are generally not connected to the specific legal system in which the synthetic structure is arranged. SPVs in a synthetic securitisation, which issue funded credit-linked notes, will of course be subject to the same lending-licence requirements as the SPV in a conventional structure, but the synthetic structure has the advantage of being able to set up an efficient structure without using an SPV.

Other legal issues discussed in this paper, such as indefinite credit events, uncertainties regarding enforceability and the risk of reclassification of the credit default swap into an insurance contract, do not arise as an effect of incompatible national legal systems, but rather as an effect of inadequately drafted contracts or an undeveloped credit derivatives market. Contract law, which nationally governs the bilateral agreements, is generally less restrictive on the parties of securitisation than, for example, Insolvency Law and other regulatory requirements. The universal principle of freedom of contract in international contract law, i.e. that free individuals, with equal bargaining power, as far as possible shall be left to arrange their contracts according to their own preferences, therefore liberates the parties to arrange the synthetic structure with a minimum of regulatory restrictions. Furthermore, although the international regulations, guidelines, definitions and master agreements regarding credit derivatives issued by ISDA have been recognised as worldwide standards, these are not legally binding to the parties, and can be contracted out of when arranging the synthetic securitisation. With a structure based on credit derivatives and bilateral

contracts, the procedure is therefore going to be more flexible, less dependent on mandatory legislation and jurisdictional differences than a structure based on the legal establishment of a separation and independent management of the assets.

## **7.4 Synthetic Securitisation - the Better Alternative for Europe**

Common law jurisdictions are in many aspects more conventional securitisation-friendly than civil law jurisdictions. They have easier formalities for asset transfer, they recognise the concept of trust, and especially the U.S. has straightforward procedures concerning security interests. But the advantages of common law jurisdictions in securitisation, and in other modern financial structures as well, has nothing to do with any superiority of the common law legal system as a whole. A majority of the modern financial structures of the world, including conventional securitisation, are products invented, developed and primarily used by the U.S. and the U.K. financial community. The structure and the rationale behind these financial structures have therefore been arranged to comply with the principles and legal instruments available in common law legal systems. When simply transferring an advanced process such as the conventional securitisation to a new legal context, problems and uncertainties will inevitably arise.

From a conventional securitisation party perspective, civil law jurisdictions often offer burdensome formalities of asset transfer and debtor notification and they traditionally lack some of the basic legal features required to set up a successive conventional securitisation. By frustrating both the legal and economic structures behind conventional securitisation, the development of the securitisation market has therefore been very slow. Generally, in order for the conventional securitisation market to develop, civil law jurisdictions have to pass new laws that are especially developed to promote and facilitate an effective securitisation practice. In countries like Spain and France, where such laws have been passed, there is an increased volume of conventional securitisation transactions, whilst countries like Sweden and Germany, which have a more conservative securitisation legislation, have not shared the same success. However, although the passing of special securitisation laws reduces the legal barriers of securitisation in civil law jurisdictions, a securitisation market that is dependent on securitisation laws to flourish will nevertheless be held back in its development. Since the creative forces of the market generally are one step ahead of the legislators in their struggle for efficiency and expansion, the securitisation markets in civil law jurisdictions will always be hampered by the slow political process of enacting new laws. In common law jurisdictions on the other hand, the conditions are the opposite: the market will continue to develop and flourish as long as the legislator do not discourage it by enacting reactionary

legislation. Hence, civil law jurisdictions will never lead, but always follow, the progress and advances of conventional securitisation. Trying to catch up and imitating the development of the big players in the U.S. and the U.K., the civil law conventional securitisation market will always have a competitive disadvantage.

The flexibility of credit derivatives, combined with the securitisation market's ability to access large quantities of capital market funds, have made the synthetic securitisation a competitive alternative to conventional securitisation in both common- and civil law jurisdictions. The liberation from legal uncertainties and concerns arising out of national, jurisdictional and structural legal differences, has however made the synthetic structure especially suitable for civil law jurisdictions. As national Property- and Insolvency Laws are of limited importance in the synthetic structure, the dealings with credit derivatives and synthetic securitisation offer the parties a greater freedom to arrange their transactions to their own preferences. Such freedom may not always be beneficial, as a majority of the legal issues in a synthetic structure arise from uncertainties in documentation and a generalising view of the transactions included. But the legal concerns of the synthetic securitisation are not consequences of the absence of traditional legal instruments and principles, since it is not traditional legal interests that are being transferred. Derivatives do not transfer or create any actual ownership or security interest in an asset, but instead create economic interests on a contractual level. The universal standards and guidelines of the ISDA, and the relatively liberal characteristics of general Contract Law, therefore enables the parties of synthetic securitisation to compete on the same legal terms and conditions, ignoring the differences of common- and civil law legal systems. In synthetic securitisation, civil law jurisdictions are therefore offered the means to be the leader, and not the follower, of the development of modern financial structures.

## 8 Conclusion

The question why the conventional- and synthetic securitisation markets develop faster in some jurisdictions than in others has no easy answer. The economic environment, differences in financing traditions and the legal regulatory basis are only a few factors that might influence the progress of securitisation. We do however know that without a strong legal foundation supporting the transactions of securitisation, there can never be any successive development. The legal risks of securitisation are impediments to an effective and flourishing market, as they contribute to the legal uncertainty that may discourage arranging parties and investors from participating in an otherwise prosperous securitisation procedure. Legislators must therefore try to keep the hostile legal risks to a minimum, so that legal barriers do not hamper the creative forces of the market.

Although the conventional- and synthetic securitisation have striking similarities in their structural arrangements, a further examination shows obvious differences in methods and transactions used when transferring credit risk. These procedural differences are also reflected in the legal concerns that have to be considered when estimating the legal risks of the two structures. Generally, the most crucial legal risks of conventional securitisation have their origin in Property- and Insolvency Law and regulatory licence requirements, whilst the most common legal uncertainties in synthetic securitisation arise from the interpretation of the contracts and a lack of an established derivatives regulation. This is the logical consequence of the most fundamental difference between conventional- and synthetic securitisation: the first structure requires a true sale of underlying assets and an actual legal separation in order to be successful, the latter contractually transfers the economic interest of the underlying assets, without engaging in a true sale.

With the origin of the legal risks of securitisation in mind, it is easier to explain the variations of success experienced by securitisation markets on an international level. As Property- and Insolvency Law and regulatory licence requirements differ quite significantly from one jurisdiction to the other, conventional securitisation suffers great difficulties when implemented into an entirely new legal system. Being invented and developed in the U.S., the conventional securitisation is structured and designed to go well with the legal conditions offered there. Other common law jurisdictions, like the U.K., have also experienced a successful development of securitisation, as these jurisdictions share some of the legal characteristics that are crucial for an effective securitisation market. Civil law jurisdictions on the other hand, have not caught up with the development of this relatively new financial instrument; a fact that could have its explanation in the incompatibility of the legal structure. By incorporating the Anglo-American conventional securitisation model into a civil law jurisdiction, some of the existing legal risks will be amplified, due to the differences in the legal foundation. To

reduce these risks, civil law jurisdictions will have to pass new laws; a process that often is time consuming and not aligned with the fast development on the capital market.

Synthetic securitisation does not share the same difficulties when implemented into a new legal system. It is true that the synthetic structure is also primarily developed and designed to fit the legal conditions in the U.S. However, synthetic securitisation does not suffer from the same incompatibility between different legal systems as conventional securitisation. The synthetic structure is not based on the idea of an asset transfer and a removal of the assets from the initiators balance sheet, and it does not condition any of the special legal instruments that are exclusive for common law jurisdictions in order to be successful. Conversely, the underlying principle of synthetic securitisation is the strictly contractual transfer of credit risk through credit derivatives, i.e. bilateral agreements that create contractual links to the underlying asset and contractual obligations between the parties. The universal principle of freedom of contract therefore gives the parties a bigger flexibility to structure and develop the synthetic securitisation to their own preferences, with a decreased interference of national mandatory legislation compared with conventional securitisation. With restrictions and legal risks arising out of jurisdictional differences reduced, civil law jurisdictions may customise and develop the synthetic securitisation, and like any common law jurisdiction, optimise the potential of securitisation to the fullest.

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