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FEATURE ARTICLE: The new Basel Capital Accord and Asset Securitisation | **CONTENTS:** Possible Taxation in Germany of Foreign Securitisation Purchasers | US asset-backed CP conduits target the Euro market

The new Basel Capital Accord and Asset Securitisation

Mayer Brown & Platt has been at the forefront of industry efforts to influence the formulation of the securitisation aspects of the New Basel Capital Accord. Indeed, we represented the European Securitisation Forum, the Bond Market Association, a group of banks which administer over 60 multi-seller ABCP conduits and a large group of credit card ABS issuers in the recent round of comments to the Basel Committee on the January 2001 ("Basel 2") proposals. The evolution of a new Accord has been, and remains, a complex process. We have highlighted some key developments below and will continue to do so in future newsletters.

Key Issues

Residual Interests – The Basel Committee itself recognised in Basel 2 that securitisation could serve as an efficient means of redistributing a bank's credit risk to other banks and non-bank investors. By providing an effective means for banks to redistribute their market risks to the capital markets, securitisation facilitates prudent risk management and diversification. Part of the Committee's proposals included a hefty capital charge for the most junior tranches in securitisation deals (first loss pieces usually retained by originators). Basel 2 provided that these "residual" interests would be fully deductible from capital – an effective capital charge of 1,250%, compared to the usual 8% for "standard" senior corporate exposures.

Industry participants made two suggestions regarding these proposals. First, a residual interest should benefit from lower capital charges when it can be established – by obtaining an external rating for example – that the risks inherent in the position are actually lower. The first loss piece of a pool of AAA-rated assets may well be less risky that that implied by a 1,250% capital charge. Second, industry participants requested the Committee to confirm that capital charges for residual interests would not exceed the total capital an originator was obligated to hold against the asset pool prior to its securitisation. Were such a "penalty" to be imposed on securitisation transactions, many of the benefits of securitisation acknowledged by the Committee might be lost.

Revolving Transactions – Many securitisation transactions, particularly credit card deals, provide for early repayment of senior tranches if certain events occur. The Basel Committee suggested that such early amortisation triggers could pose special risks to originators of such assets, including the risk that retained junior tranches in such deals could ultimately absorb more than their share of credit losses on the securitised pool of assets. Thus, the Committee proposed in Basel 2 that originators in deals with early amortisation features hold additional balance sheet capital against an amount equal to 10% of the portfolio sold (or a higher percentage in the discretion of the originator's banking supervisor). Industry participants argued strongly that there is no greater risk inherent in a pool of assets due to an early amortisation feature. Whether senior or junior investors

Background

A summary of the January 2001 proposed Accord is at: www.securitization.net/content_template.asp?URL=/knowledgebank/legal/basel_0212.asp

The full proposals are at: www.bis.org/publ/bcbsca.htm

The full comments received by the Committee are at: www.bis.org/bcbs/cacomments.htm

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receive greater or lesser shares of collections is simply not related to the creditworthiness of the underlying assets. Thus, no additional capital charge should be assessed. We believe that this argument will prove persuasive in the end and that no new and onerous capital requirements will be imposed where they are not justified, but this may not be reflected in the next round of proposals from the Committee.

Implicit Recourse – The Committee suggested a particularly draconian solution to what it terms a "moral" risk inherent in securitisations. Basel 2 proposes that, if an originating bank provides support that goes beyond its contractual obligations, such as exchanging non-performing for performing assets, then (1) for a first-time "offence" all of the assets associated with the entire transaction (not just the tranche rescued) would be moved back onto the bank's balance sheet and (2) for a second-time offence all of the bank's securitised assets would be moved back onto its balance sheet! In addition, in both scenarios, the bank must make a public disclosure that it has provided implicit recourse. Industry participants strongly prefer a rule that empowers bank supervisors to fashion appropriate remedies in the event they determine that implicit recourse has been provided.

Super-Senior Positions in Synthetic Securitisations – In a typical synthetic securitisation transaction, an originator retains the most junior, "first loss," position (say, €200 million out of a €2 billion portfolio) in an asset pool as well as the most senior position (say, €1.4 billion). The middle position (say, €400 million) – which is senior to the first loss piece and typically legally subordinated to the most senior position – is subject to a credit default swap with a third party SPV. The SPV then secures the credit default swap with AAA-rated securities acquired with funds raised in the capital markets. Because the credit default swap supporting the middle position is itself backed by AAA-rated securities, the most senior risk position is often called the "super-senior" position.

The Committee proposed that the implied AAA credit quality (and, as a result, lower capital weight) of this super-senior position cannot be recognised unless the originator has hedged it with a third-party. We believe such a swap is unnecessary, so long as the originating bank deducts the retained first loss position from capital and the (middle) position demonstrably legally subordinated to (or pari passu with) the super-senior position achieves the highest possible rating (AAA) from at least one rating agency.

Timing

In September or October, we expect the Committee to circulate an internal draft of its new internal ratings based ("IRB") approach for securitisation to certain market participants ("Basel 2½"). Given the significant amount of work to be done, it is more likely that the Committee will issue revised proposals ("Basel 3") closer to the second quarter of 2002 rather than by the January 2002 deadline they have announced.

Possible Taxation in Germany of Foreign Securitisation Purchasers

Some German regional tax authorities are seeking to treat certain foreign receivables purchasers as tax resident in Germany. These tax authorities argue that if the receivables are serviced by companies tax resident in Germany then the place of management of the foreign purchaser should be located in Germany.

Such a position would make such foreign purchasers (including multi-seller asset backed commercial paper conduits) subject to German tax, although not necessarily tax paying. Potential corporate income tax liability is not the principal concern, as expenses of receivables purchasers are generally comparable to their income, and as a result they generally do not derive a significant taxable trading profit. However, the potential trade tax charge could be significant.

German Trade Tax Basics

Trade tax in Germany is a municipal tax, meaning that only German municipalities have the right to levy the tax and to stipulate its rate. The effective trade tax rate currently ranges between 15% and 22%. Trade tax is levied on a company's trading profits after making certain adjustments. In particular, 50% of the company's interest expense on long-term financing must be added back to determine the adjusted trading profit subject to trade tax. Assuming that the trading profit is almost nil, the trading profit subject to trade tax would generally amount to 50% of the interest expense on long-term financing. In the example above, trade tax charges could roughly be calculated as follows: (50%) x (interest expense on long-term financing) x (effective trade tax rate) = trade tax liability.

Should a foreign purchaser be subject to German taxation, the competent tax office would be the same as that of the German servicer performing servicing activities on behalf of the foreign purchaser. Trade tax is usually levied on the basis of quarterly prepayments following a assessment notice issued by the competent tax office. There is a penalty for late payment amounting to 1.0% of the tax due.

Although under current law regional tax authorities are not prevented from claiming trade taxes from foreign purchasers under the circumstances described above, they have so far chosen not to do so. We understand that not all of the regional tax authorities in Germany desire to claim such taxes, and that there are some efforts underway to reach a uniform national position on this issue. No legislation or rule-making has yet been publicly introduced to deal with this issue.

Positions and Issues

For trade tax to be payable, the German tax authorities would need to establish that both (a) the foreign purchaser either has a "place of management" in Germany (including as a dual-resident company) or has a "permanent establishment" in Germany and (b) the purchaser's funding is "long-term" with a maturity of more than one year. In the view of tax advisors with whom we have spoken on this issue, the first position will be difficult to establish. At least in the case of conduits which fund themselves in the US and Euro CP markets, the second position may also be difficult to establish depending on the facts.

According to Sec. 2 para 1 of the German Trade Tax Code, a trading business for which a permanent establishment is maintained in Germany is subject to trade tax. According to Sec. 12 sentence 1 of the German Fiscal Code, a permanent establishment is defined as a fixed place through which the business of the enterprise is carried out. Since a foreign securitisation purchaser usually does not have a fixed place of business in Germany, this general requirement of a permanent establishment usually is not met.

However, Sec. 12 sentence 2 of the German Fiscal Code also provides that the place of management can be a permanent establishment. The German Federal Tax Court has held that the place of management may be located in Germany even if there is not a fixed place in Germany. The German tax authorities seem to be arguing that a German resident servicer which administers and collects the purchased receivables establishes a place of management of the purchaser in Germany.

This position seems to ignore several important structural characteristics of securitisation transactions. When a foreign securitisation purchaser is set up, both the registered office and the place of management of the purchaser are typically located abroad. Because the purchaser maintains a functioning permanent establishment abroad, all of its activities should be attributed to this foreign permanent establishment.

Not all Multi-Seller Activities Covered

In the case of a multi-seller ABCP conduit, even if trade tax applies, not all of the conduit's activities should necessarily be subject to trade taxes, only those serviced by a servicer tax resident in Germany. In the case of pools of assets serviced by parties resident in countries other than Germany, the German tax authorities might argue that the purchaser has several places of management in the different countries. Such a view might be based on recent decisions of the German Federal Tax Court stating that a company can have several places of management. As a result, in the case of a multi-seller structure, only the accounts which are serviced by the German servicer should be attributed to Germany, and only the foreign purchaser's trading profit generated from these receivables should be subject to German trade tax.

We understand that the Federal Tax Court decisions mentioned above concerned cases involving facts which are different than those in a securitisation transaction, namely companies moving their place of management into Germany during a fiscal year because the manager of the foreign company moved to Germany. Accordingly, it should still be possible under current case law to argue that a foreign purchaser has only one place of management. If so, and if the foreign purchaser is structured to provide that its management is located abroad, then the purchaser's activities should not be attributed to a German permanent establishment and no trade tax would be payable.

Long Term Financing

ABCP conduits that fund themselves through commercial paper cannot be certain of having their CP treated as short-term financing, because the programmes pursuant to which CP is issued are customarily in place for periods in excess of one year. That CP typically matures in less than one year is not decisive. We understand however that, if CP is sold to different investors on each roll-over date, that lack of investor continuity could help establish that the CP in fact constitutes short-term financing for trade tax purposes.

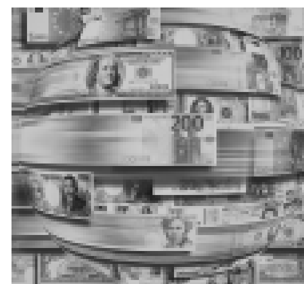
US asset-backed CP conduits target the Euro market

Sponsors of asset-backed commercial paper (ABCP) conduits in the US are looking to vary their funding sources by bolting on the capability to issue ABCP in both the US and European (Euro) markets. However, ABCP issued in the US may not be familiar to Euro ABCP investors – conduits may need to be 'retrofitted' to enable dual issuance. Key issues to be aware of include:

1 Securities Act

ABCP conduits in the US are usually structured to exempt their securities from registration under the 1933 Securities Act (either as 'private placements', or under Regulation S). This can raise problems in the Euro ABCP markets, where such structures may not be standard.

- Issuers seeking to rely on the 'private placement' exemptions (available under either section 4(2), or section 3(a)(3) of the 1933 Act), can only avoid registration by selling their ABCP to institutions recognised as 'qualified institutional buyers' or 'accredited investors'. They must also comply with other restrictions on the terms of the ABCP, including restrictions on transfer (holding periods before resale is allowed), and/or limitations on eligible investors in secondary sales. These characteristics are not standard for ABCP sold in the Euro markets. Not all Euro ABCP investors are familiar with reviewing and signing investor representation letters. US conduits could be limiting the pool of Euro investors by issuing ABCP carrying US market purchaser and transfer restrictions. What is more, the conduit's Euro ABCP would be a non-conforming, relatively illiquid product – potentially less attractive to investors than ABCP issued in line with Euro market practice.
- Exemption from registration under the 1933 Act can also be obtained by US conduits issuing ABCP under Regulation S. To qualify, the ABCP is subject to holding periods before resales are permitted, and investors must certify that they are not US persons. Once again, however, ABCP issued with these characteristics is not standard in the Euro markets. This makes the ABCP a less attractive product to potential Euro investors.



Alternative solution: By setting up a separate, non-US, entity as co-issuer, US conduits can issue Euro ABCP with terms that are standard in the Euro market, while still qualifying for Securities Act exemption in the US. It is vital that these transactions are structured to ensure that the co-issuer is characterised as a 'foreign issuer', and that its ABCP is unlikely to be integrated with the US ABCP issued by the conduit. Both points are fact-

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sensitive, and depend on the co-issuer's location, capital structure and the terms of its program documents.

2 Investment Company Act

- To avoid registration as investment companies, US-based conduits rely on the 'private investment company' exemption in s3(c)(1) of the Investment Company Act. This prohibits them from making 'public offerings' of their securities. This does not raise problems for issuers relying on the private placement exemptions outlined above. However, ABCP issued in the Euro market by a conduit relying on the Regulation S exemption does not usually qualify as a private offering. Until this is clarified by the SEC, such issuers need to look elsewhere for exemptions from Investment Company Act registration. Conduits that have used a co-issuer structure to qualify for Securities Act exemption might find it impossible to rely on the s3(c)(1) exemption. This will be the case where the co-issuer is a subsidiary of the conduit, or has such a close business arrangement with it that the two might be considered 'integrated'. Under these circumstances, ABCP issued by the co-issuer in Europe under the Regulation S foreign issuer exemption, will nevertheless be attributed to the US conduit, most probably violating the s3(c)(1)'s 'no public offering' restriction. Determination of 'integration' is fact-specific and if the co-issuer cannot be structured to avoid this problem, then it is best to seek Investment Company Act exemptions elsewhere.

Alternative solution: The most commercially practical alternative to s3(c)(1) is the exemption under Rule 3a-7 of the Investment Company Act. This ignores the public offering and integration issues. Instead it imposes two main restrictions on issuers. Firstly, the conduit/co-issuer can only issue securities whose repayment depends on cashflow from financial assets (forcing the conduit to limit the assets it funds to 'financial assets'). And secondly, the conduit/co-issuer must grant security interest in its assets to an independent collateral trustee to secure repayment of the ABCP. Even allowing for these limitations, this Rule provides conduits and co-issuers with the maximum flexibility.

3 What next?

The fast-growing Euro ABCP market is increasingly attractive to US sponsors. However, it is important for them not to lose out on important exemptions under the Securities Act and the Investment Company Act. Careful analysis of the US-based conduit, as well as of the sponsor's ultimate business objectives, will help to determine which strategy to adopt.

Next Issue

In the next edition of the European Securitisation Newsletter, we will cover:

- *The impact of the Hollywood Funding case on wrapped deals*
- *New developments in English law on fixed charges*
- *The pros and cons of French FCCs as securitisation vehicles*

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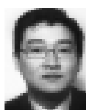
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