

SECURITISATION IN THE CAYMAN ISLANDS

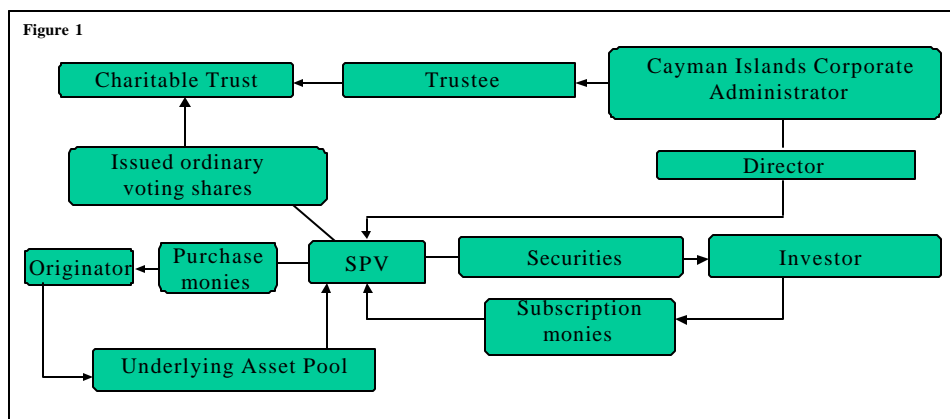
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In a competitive marketplace, such as that represented by offshore jurisdictions in securitisations transactions, an arranger and its counsel need to feel confident that the chosen jurisdiction can deliver the highest level of service from within a stable, well developed and professional, legal and regulatory framework. This goes a long way in explaining the continued growth of the use of the Cayman Islands special purpose vehicle ("SPV") in securitisation transactions.

The securitisation of assets involves the conversion of the current and future income streams of the assets into securities (either debt instruments or equity) that are issued by the SPV holding the assets. These income streams are used to pay interest on the securities issued. The purpose of a securitisation for an arranger is to achieve advantageous accounting treatments (accelerating the recognition of income and loss; improving the return on assets and capital asset calculations) and regulatory capital relief (the removal of the underlying assets from the balance sheet). From the point of view of an investor, it may give e.g., onshore institutional investors precluded by their local regulatory laws from investing in certain types of assets, the opportunity to do so through the purchase of the securities, as well as having credit enhancement and liquidity support advantages (through swaps - currency, interest (or in synthetic structures, credit default)) designed to modify cashflows from the underlying assets.

THE SPV

The basic structure of a typical off balance sheet financing in a securitisation is set out in Figure 1 below.



The SPV will be an 'orphan' company owned by a share trustee under the terms of a trust arrangement (the shares being held on trust for either a charitable purpose or uniquely, under The Special Trusts (Alternative Regime) Law 1997, for the purpose of the transaction itself), thus ensuring the transaction is "off the balance sheet" of any party to the transaction. A Cayman Islands exempted company SPV can be set up in less than 24 hours. It must have a registered office in the Cayman Islands but there is no longer any requirement that an annual meeting of the Board of Directors be held in the Cayman Islands.

The SPV must keep a register of shareholders either at its registered office or such other place as is notified to the Registrar of Companies, but this register is not available for inspection by the public. On an on-going basis, the annual reporting requirements are minimal, consisting of a statement signed by a director or the company secretary confirming that the company has conducted its operations mainly outside the Cayman Islands.

Regulation: there are no restrictions relevant in securitisation transactions in respect of the SPV; it can lend, borrow or issue debt securities without being required to be licensed under local law. There is no specific regulation of debt issues unless they are listed on the Cayman Islands Stock Exchange.

Filings: no government authorisations or licences are required to incorporate the SPV, and no filings are required in the Cayman Islands with the issue of debt securities.

Capital requirements: there is no minimum capital requirement for an SPV. It is normal practice for an SPV to have an issued ordinary share capital of US\$1,000 held on charitable trust, and it is this sum which at the end of a transaction is available for distribution to the beneficiaries of the charitable trust.

The Cayman Islands remain relatively inexpensive (particularly as compared with, for example, Jersey). Fees payable to the Cayman Islands Government (on incorporation and then annually) are based on the SPV's authorised share capital, which, in the majority of cases is the minimum of US\$574. Registered office fees, local administrators fees and legal fees are also relatively inexpensive.

THE LEGAL FRAMEWORK

Cayman Islands law is essentially based on the English common law system so that the central issues of corporate power, directors' fiduciary duties, corporate personality, limited liability and corporate benefit are in all substantive respects the same as the position under English common law.

At the same time, however, Cayman Islands commercial legislation benefits from being much less cumbersome in many of the areas that have caused considerable difficulty and uncertainty under the corresponding English statutes. For example, Cayman Islands Companies Law provides that shares are redeemable not only out of profit but also from the credit balance on the share premium account or from capital, enabling an equity instrument to have much of the

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economic substance of debt. In addition, while under English law it is unlawful for a company to directly or indirectly provide finance for the acquisition by a third party of its own shares (so-called "financial assistance"), financial assistance in the Cayman Islands is not unlawful. The directors must simply ensure that the transaction is demonstrably for the material benefit of the company. This is generally dealt with by ensuring the transaction documentation contains sufficient limited recourse provisions and by providing for the SPV to be paid a transaction fee (usually by the arranger), to evidence a profit. A further plus point is that under the Cayman Islands Companies Law, contractual subordination is given statutory force. This means that both those structuring transactions and creditors can be confident that a priority of payments agreed by a Cayman Islands issuer is enforceable by creditors even if those creditors do not have the benefit of an associated security interest. This ensures that a waterfall will bind all creditors even where the company has granted only a negative pledge rather than a more rigid form of security interest. This creditor-friendly approach obviously gives more flexibility in structuring transactions.

1. ARRANGER CONCERNS

An arranger (and its rating agency) will want to be comfortable on a number of issues. First, that the SPV is bankruptcy remote and that there is a true sale to remove the underlying asset pool from the arranger's bankruptcy estate - and it is only in very specific cases that the separate corporate personality of an SPV will be ignored so as to allow creditors access either to the SPV or its shareholders. Most such relevant cases have typically been English and have involved fraud. It is of course essential to ensure that there are adequate corporate formalities for the SPV to ensure that there is no risk it will be treated as an agent of the arranger or a sham. This is part of the role of the local administrator.

Secondly, that the business of the SPV is restricted to the activities which ensure a sufficient cash flow to pay the securities. The objects clause of the memorandum of association of the SPV will be drafted accordingly.

Thirdly, that there is non-petition language in the agreements between the SPV and transaction parties, which, together with the limited recourse language is effective under Cayman Islands law in limiting the creditor's right to petition as an unpaid creditor.

Fourthly, that the share trustee (who will hold the voting shares) will not exercise its rights as a shareholder to liquidate the SPV (since it is shareholders, rather than directors, who hold this power) until after an agreed period or, indeed, do anything to cause the SPV not to comply with its contractual covenants in any of the transaction documents. This is dealt with in the trust document executed by the local administrator acting as share trustee.

TAX

As a tax-neutral jurisdiction, the Cayman Islands imposes no corporation taxes on any company carrying out either domestic business or offshore business. This is supported by a written tax undertaking from the Government of the Cayman Islands that no taxation introduced for a

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period of at least 20 years from the date of the undertaking will apply to the SPV or the holders of its securities. This period can be extended if the particular transaction should require it.

Also, there is no withholding tax on any payment of principal or interest made by a Cayman Islands SPV.

Stamp duty only arises in the Cayman Islands where the relevant instrument is physically brought into the Cayman Islands. Accordingly security documents are invariably executed by power of attorney outside the Cayman Islands. If it is preferred that documents are executed by directors of the relevant Cayman Islands SPV, the documents need to be executed by the directors prior to execution by other parties or held in escrow by the directors until they have been removed from the jurisdiction.

The use of excellent Cayman Islands administrators also means that Cayman Islands companies are centrally managed and controlled in the Cayman Islands, which helps onshore tax counsel gain comfort that the Cayman Islands SPV will not be taxable in the relevant onshore jurisdiction except, in certain cases, where the Cayman Islands SPV is structured so that it is purposely tax resident in a particular jurisdiction.

- (1) *Given all the uncertainty caused by the tension in relations between the UK and Jersey with respect to the EU Code on Taxation, the Cayman Islands looks set to further enhance its position as the domicile of choice for SPV's in securitisation transactions.*

SERVICE PROVIDERS

Professional service providers are vital to ensure the integrity of the SPV and the structure of the transaction. It is essential that all the necessary corporate formalities and procedures are complied with. In particular, the SPV may need to be centrally managed and controlled in the Cayman Islands (or another non-taxing jurisdiction), to ensure that it is not tax resident in the United Kingdom or elsewhere, the effect of which might be catastrophic to the transaction. This may require key commercial decisions relating to the activities of the company to be made at board meetings that are held in the Cayman Islands. This in turn requires competent corporate administrators who understand the commercial rationale and the legal structures of the transactions, and are accordingly able to make informed decisions on behalf of the relevant SPV.

The Cayman Islands have excellent professional service providers with extensive experience. There are a large number of fully qualified and experienced professional trust and corporate administration companies that act as trustees and who provide directors and other corporate services to SPVs. Walkers have recognised the importance of providing a "one-stop" service and has established a wholly owned affiliate, "Walkers SPV Limited", in order to offer a full corporate administration service for SPVs. It is often a listing requirement for the accounts of the SPV to be audited prior to the listing of any of its securities. One of a number of continuing obligations of the SPV after the initial issuance of its securities can also be an annual audit of its

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accounts. To this end, all the major accounting firms are represented in the Cayman Islands offering full auditing services.

THE TYPICAL TRANSACTION:

COLLATERALISED DEBT OBLIGATIONS (CDOs)

The issuance of collateralised debt obligations (CDOs), including collateralised bond obligations (CBOs) and collateralised loan obligations (CLOs), is a large segment of the ABS market. A typical transaction will involve the transfer of the securities or loans by the originator to a bankruptcy remote Cayman Islands SPV and the issuance by the Cayman Islands SPV of securities secured by the cash flow on the underlying assets. In a CDO the Cayman Islands SPV issues a number of tranches of securities - notes and equity, rated and unrated. Tranching allows access for investors with different risk appetites. Each rated tranche will receive an investment credit rating from one of the credit agencies with the senior tranche usually receiving the highest credit rating. The most subordinate piece of the structure is the unrated equity class, generally being preference shares, which will be exposed to the greatest amount of risk but which has the potential to produce the highest return. The rating or otherwise of a tranche will denote its position in the priority of payments. The cash flow of the collateral is passed through to pay the principal and interest of the CDO tranches. Interest payments received from the collateral are used to pay interest and principal payments are used to pay principal. The senior tranches will have first claim on cash flows. The last tranche to be repaid will be the equity tranche.

CDO transactions generally take one of three structures: cash flow, market value and synthetic. In cash flow CDOs, the proceeds of the cash flow generated by the underlying assets are used to repay the principal and interest of a tranche of securities. These structures can themselves be characterised as either traditional balance sheet (which involve the removal of assets from the arranger's balance sheet, to improve liquidity, gain regulatory capital relief and improve the return on risk capital) or arbitrage transactions (which present opportunities for investors to take advantage of the spread differential between the rate of interest earned on the underlying assets and the interest yield on the tranches of securities issued).

In market value CDOs, it is the trading and sale of the underlying assets which are used to repay the principal and interest of a tranche of securities. This changes the emphasis to the market value and liquidity of the underlying assets, and it is the collateral manager's activity and ability to maintain the value of the portfolio which is key.

Synthetic CDOs involve the use of credit derivatives to transfer the credit risk of assets from an arranger's balance sheet to an SPV where there is no actual transfer of those assets - the credit derivative, usually in the form of a credit default swap, will be entered into between the SPV and the arranger; the securities are issued by the SPV and the proceeds used to purchase collateral for the credit default. The arranger agrees to make periodic payments to the SPV in return for the SPV agreeing to make a payment to the arranger if certain credit events occur. Synthetic CDOs are seen in a growing number of transactions, and offer a number of

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advantages including the avoidance of stamp duty issues that can arise with the transfer of assets; no difficulty with non-assignability provisions in any documentation involved at the underlying assets level and no client confidentiality issues involving rating agencies reviewing the terms of loans comprised in the underlying assets.

The Cayman Islands are a stable, mature financial centre providing a professional, legal and regulatory framework for offshore SPVs and securitisation transactions such as the typical CDO transaction described above. The depth and breadth of the expertise of its local service providers and its facilitative features ensures that it will continue to maintain its dominant role in the structured finance industry.

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