SPECIAL PURPOSE VEHICLES AND THE SECURITISATION INDUSTRY IN IRELAND – Q&A

IDSA
Irish Debt Securities Association

Special Purpose Vehicles and the Securitisation Industry in Ireland – Q&A

What is a securitisation?

Securitisation is the creation of tradeable securities out of an income stream that is generated by financial assets. Securitisation provides for pooling of various types of financial assets, such as debt (for example, residential mortgages, commercial mortgages, auto loans, credit card debt obligations, trade receivables, invoices) and other assets that generate cash flows. The assets and cash flows are pooled and isolated into an entity (a securitisation company) which borrows from investors to fund the acquisition of the assets.

Why securitise?

Securitisation helps both issuers and investors to diversify risk across asset classes, and enhances access to funding. Originators (banks, trading companies, credit card providers etc.) wish to sell assets or borrow against assets. By securitising the assets, originators can obtain cheaper financing or a better price for the assets because they can isolate the assets from other risks (for example the risk that the originator becomes insolvent or liabilities of the other activities of the originator can affect the assets securitised). Banks, by securing assets such as mortgages or credit card loans, can access funding and release regulatory capital to fund more lending to the economy and reduce the risks on the balance sheets.

Investors can more accurately price the debt they are willing to lend as the assets against which they lend are isolated from unrelated risks and the credit analysis can be simplified and a more accurate price for the credit can be determined. Since risks and asset quality can be more easily quantified, the debt of securitisation companies can more easily obtain a rating. This makes it less capital intensive for regulated investors to buy rated bonds so they can provide cheaper financing to businesses. In many cases the debt of the securitisation structure, or special purpose vehicle (SPV) has a higher rating than the originator's rating. Also, listed bonds of an SPV are tradeable securities so the securitisation process can convert illiquid loans into liquid, tradeable securities.

How common is securitisation?

Securitisation originated in the US in the 1970s when mortgage bonds were first traded. Since then, securitisation has become very common in the US, and increasingly so in Europe. Traditionally, Europe has had a great reliance on banks to provide funding to the economy than the US. The ratios of securitised loans and corporate bonds to total financing volumes in Europe is of the order of 20 per cent, compared to over 60 per cent in the US. Issuance in the US also dwarfs that in Europe. From 2006 to end Q1 2016 for example, the value of European issuances has been €4,071 billion compared to €15,071 billion in the US. However, for many reasons, the traditional means of raising finance in Europe is being challenged and securitisation is emerging as a significantly important financing channel to bridge the funding gap.

What European countries have securitisation regimes?

- Ireland (Section 110 Securitisation Company)
- France (FCT and SDT)
- UK (Securitisation Company)
- Luxembourg (SICAV, Securitisation Company)
- Netherlands (Dutch Special Purpose Vehicle)
- Italy (Law 130 Company)
- Malta (Securitisation Vehicle)
- Belgium (VBS/SIC)
- Portugal (FTC/STC)
- Spain (FTs)

What is EU policy on securitisation?

The EU Commission wishes to revive the European securitisation market, to help deliver stronger capital markets and funding for European small to medium enterprises (SMEs), homeowners and consumers as it considers that securitisation has the potential to make a considerable contribution to the economy by providing finance to both European businesses and European households. Permitting banks to sell assets to other capital market participants in a regulated, transparent manner enables banks and other financial institutions to lend more without raising new capital. This unblocks lending channels and lowers the cost of funding for businesses and households.

The EU Commission views securitisation as a key funding channel for the economy, and says that rebuilding securitisation to its pre-crisis average could provide an extra €100 billion of credit to the economy.

Through the Capital Markets Union (CMU – the project to build a true single market for capital), the EU is seeking to develop a simple, transparent and standardised (STS) securitisation market as a vital element of the European Commission's capital markets union.

When publishing the European Commission's securitisation proposals under the European CMU (Capital Markets Union), Lord Hill, the then European Commissioner for Financial Stability, Financial Services and Capital Markets Union said that Europe needs stronger, deeper capital markets.

"The benefits of stronger capital markets are also clear. We could give Europe's businesses more choices over funding, helping them to invest and grow; increase investment in infrastructure; draw in more funding from outside the EU; help businesses sell into bigger markets; and help those saving for their old age. And, by reducing reliance on bank funding, we could help make the financial system more resilient, particularly in the Eurozone," he said.

The strong credit performance of European securitisation before, throughout, and since the financial crisis has been recognised by the European Banking Authority (EBA) in its Report on Qualifying Securitisation, and by the EU Commission, which highlighted that simple and transparent AAA securities had a default rate of just 0.1 per cent during the financial crisis.

What EU law applies to securitisations?

EU law relating to securitisations includes: the Capital Requirement Regulations (also known as the risk retention rules); Financial Vehicle Corporation (FVC) disclosure rules; European Market Infrastructure Regulations (EMIR) for derivatives entered into by SPVs and others.

How does Ireland compare to other EU securitisation jurisdictions?

Ireland is the leading European jurisdiction for the establishment and servicing of securitisation structures. As of March 2016, some 1,400 special purpose vehicles (SPVs) were established in Ireland, representing almost a quarter (24% of FVC assets) of the European industry.

How many people work in the securitisation industry in Ireland?

More than 1,100 people work across Ireland's securitisation sector.

What do they do?

The securitisation industry encompasses a wide variety of activity. This ranges from auditing and accounting activities - for example, each securitisation company needs to draw up a set of accounts in each year to reflect its profit and loss, balance sheet etc., to administrative tasks, ensuring compliance with both Irish and international regulation, company and tax laws. A corporate service provider will often undertake these tasks for securitisation companies. In addition, lawyers will advise on the legal aspects of the transactions entered into by the securitisation company, while listing agents will organise the listing of the debt of an SPV. Where the SPV owns assets that are serviced or administered from Ireland (these can include non-Irish assets as well), this servicing activity can be carried on in Ireland.

What benefits to the economy arise from securitisation?

It has been estimated that for every 1.5 SPVs that are established in Ireland, approximately one job is created, with a direct contribution, from the establishment and servicing of the structure, to the economy of €120,000 for each SPV created. On an annual basis, the corresponding direct economic contribution is of the order of €112 million. However, these figures understate the wider economic importance of securitisation as for example the management and servicing of the assets of the structure e.g. loan servicing, trustee services etc, also represent an economic contribution.

What is the view of the policy makers, including the Irish Central Bank, on the securitisation Industry?

Securitisation in Ireland is predominantly international, with 86 per cent of Irish SPVs set up on behalf of non-Irish sponsors. The US and UK account for almost half of all Irish domiciled SPVs (45%), according to Central Bank statistics from Q4 2015.

Given that the majority of the assets and liabilities of these FVCs and SPVs are located outside of Ireland, they have very limited direct links to the Irish economy. This means that such structures have little exposure to Irish-resident assets and -resident investors. As such, there is little, if any, systemic risk considerations with Irish SPVs.

There is a recognition amongst policymakers, both in Ireland and across the EU, that the development of a more diversified funding structure for SMEs is important both for financial stability, as well as to ensure growth in a restricted credit environment.

In May 2016 for example, Irish Central Bank Governor Philip Lane said that "Market-based debt funding provides an important alternative to bank-based debt funding, with multiple funding channels a key element in the design of a resilient financial system." He also called for "an enhanced role for market-based finance that has the potential to foster greater risk diversification, while also enhancing financial stability by limiting the fallout from banking crises."

Ireland's reliance on traditional forms of bank credit has also been identified as a weakness. A policy paper published in Ireland's Economic and Social Review, a journal for economics and applied social science, noted that the scale of the banking crisis in Ireland brought to the fore concerns regarding the reliance of domestic enterprises on traditionally intermediated bank credit as the main source of external financing. As such, the paper noted that this level of reliance on a single main source of credit "heightens the vulnerability of domestic enterprises to supply shocks in that market and a greater risk of facing binding credit constraints. Indeed, there is clear evidence in the post-crisis period that such risks have materialised and that investment and employment amongst domestic small- and medium-sized enterprises (SMEs) have been negatively affected by credit constraints".

Further, the Government's Medium-Term Economic Strategy 2014-2020, placed the financing of growth as a core pillar of its development strategy. Within this pillar, a commitment was given to foster the financial system in Ireland to be a world leader in the provision of a diverse and innovative suite of financing products for Irish SMEs. This was backed up by a commitment to develop a more diversified and stable financial system with increased capital market financing and a greater involvement by institutional investors and alternative finance.

SPVs, Securitisation and Section 110

What is the framework for securitisation in Ireland?

Section 110 is, in effect, the framework for securitisation in Ireland. Specifically, Section 110 is a provision of the Taxes Consolidation Act 1997 as amended and it provides that the calculation of the profits of a section 110 company for tax purposes effectively mirror its commercial accounting profit. It also provides that, subject to compliance with some stringent anti-avoidance legislation, a deduction is available for profit dependent interest. These provisions when taken together typically result in the tax neutrality of a section 110 company.

What types of transactions use Section 110 Companies?

Section 110 companies undertake a broad range of securitisation and financing activities. These include:

- Collateralised loan obligations (CLO): In these transactions, a securitisation company acquires commercial loans and issues bonds to finance that acquisition. The bonds are typically listed on a stock exchange;
- Residential mortgage backed securities (RMBS) and collateralised mortgage backed securities (CMBS): banks often wish to securitise residential or commercial mortgages and will often do so through a section 110 company. The structure is quite similar to a CLO transaction;
- Loan origination/direct lending: due to the EU's over reliance on bank lending to finance economic activity, Section 110 companies are often formed as a means of providing finance to business and non-business customers. Where section 110 companies provide loans to Irish consumers, they are governed by the relevant consumer protection legislation and the various codes of practice of the Irish Central Bank;
- Capital raising: Section 110 companies may be set up by corporate groups in Ireland and elsewhere to issue bonds or borrow money to finance the group's activities, for example the Section 110 company may be the bond issuer for the corporate group;
- Investment funds: investment funds often set up section 110 companies as subsidiaries in order to isolate and hold particular assets within their portfolios. These companies are often 100 per cent funded by the investment fund.

What do we mean by tax neutrality?

Tax neutrality simply means that the section 110 company is taxed on all of its income (after costs) but will obtain a deduction for its expenses paid out to its investors. Effectively, international investors will be taxed in accordance with the rules in their jurisdiction but will not usually be liable to Irish tax. Certain investors will pay tax on their income (e.g. banks, companies), while others won't as their local law specifically exempts them from tax in their jurisdiction (e.g. soverign wealth funds, pension and investment funds).

How does the tax regime compare with other investment vehicles in Ireland?

Like many jurisdictions, Ireland offers a number of tax neutral ways for investors to invest in assets. These different structures include:

- Investment fund: these can be structured as companies, trusts, limited partnerships or contractual vehicles. Broadly, a full tax exemption applies to the entity and non-Irish resident investors, wherever located, incur no Irish tax on their investment in an Irish investment fund;
- REIT: a real estate investment trust benefits from a full exemption on tax on its real property investments, but must distribute the income to its investors. Non-Irish resident investors do not typically pay tax on gains from sales of REIT shares. Non-Irish resident investors can incur a dividend withholding tax (depending on the applicable treaty rate, or if no treaty applies 20%) on distributions of income;
- Unit linked insurance policies: investors can take out an insurance policy which is linked to a particular underlying investment. The insurance company typically obtains a deduction for payments out under the policy so incurs no tax on the income used to fund the investor's return. Non-Irish resident investors do not pay Irish tax on the return from the policy;
- Section 110 companies, as discussed above, are taxable on all of their income and gains at 25 per cent. A deduction is available for most payments out to investors (subject to compliance with stringent anti-avoidance legislation) so that ultimately the section 110 company should not pay a significant amount of Irish corporation tax. Overseas investors in section 110 companies will generally not pay Irish tax unless they are located outside the Irish treaty network and invest in a non-public bond.

In summary, all of these vehicles operate in fundamentally the same way: they are tax neutral. i.e. the vehicle typically pays little Irish tax and the investors are taxed in accordance with the law applicable to them. Non-Irish investors are typically subject only to tax in their jurisdiction of residence or establishment. The rules to achieve this for a Section 110 company are more stringent than for other investment products.

Are Section 110 Companies regulated?

Yes. Section 110 companies are subject to various forms of regulation. These can include:

- Irish company law;
- Irish tax law;
- the listing rules of any stock exchange on which the bonds are listed;
- EU regulations including the Transparency Directive, Prospectus Directive, Capital Requirements Directive and Market Abuse Directive;
- Financial Vehicle Corporation (FVC) rules requiring disclosures on a quarterly basis to the Irish Central Bank and alternatively the Irish Central Bank's non-FVC reporting requirements.

What assets can a Section 110 Company invest in?

Section 110 companies can invest in a broad range of financial assets including shares, bonds, debt, derivatives, leases and loan receivables, bills of exchange, commercial papers, commodities that are traded on a recognised commodity exchange etc. A Section 110 company can also invest in contracts for insurance and reinsurance (i.e., to securitise insurance and reinsurance receivables), as well as plant and machinery, i.e., they can be used for aircraft and equipment leasing.

What assets can a Section 110 Company not invest in?

While the scope of assets in which Section 110 companies can invest in may be broad, there are restrictions. In particular, they cannot invest in property, be it Irish or non-Irish.

Is there anti-tax avoidance legislation?

Extensive anti-tax avoidance legislation applies to section 110 companies, for example:

- Section 110(5) TCA denies deductions for payments by section 110 companies where the payments are part of a scheme or arrangement the main benefit, or one of the main benefits, of which is to obtain a tax relief or a tax benefit.
- Section 110(4A) TCA: this provision was introduced to address hybrid instrument concerns and is compliant with OECD BEPS rules. Broadly, it provides that no deduction is available for profit dependent interest unless the interest is:
  - » payable to an Irish resident;
  - » payable to unconnected pension funds, government bodies or other investment vehicles in tax treaty countries; or
  - » subject to tax in a treaty partner country on the payment by the section 110 company (but specific rules apply to listed bond issuances).
- Section 811A TCA is the generally applicable anti-avoidance provision in Irish law and it applies to all transactions including those by section 110 companies.

Are Section 110 Companies secretive?

No. Section 110 companies are fully transparent. Disclosure obligations applicable to a section 110 company include:

- filing of accounts and other information in the Companies Registration Office like all other companies;
- extensive disclosures required by the rules of the stock exchange on which the bonds of a section 110 company are listed;
- extensive disclosures can be required by the Market Abuse Directive, Transparency Directive and Prospectus Directive where listed debt is issued in Europe;
- filings with the Irish Revenue authorities (and possibly non-Irish revenue authorities) in relation to taxable profit and activities;
- disclosures under the OECD Common Reporting Standard and the US FATCA rules;
- disclosures to the Irish Central Bank under the financial vehicle corporation (FVC) rules and non-FVC reporting.

SPVs, Securitisation and Charitable Trusts

Why do SPVs use charitable trusts?

The use of a charitable trust structure ensures that the SPV should not be affected by any legal claims against the originator. In order to ensure that SPVs are isolated from risks that are not inherent in the assets acquired, it is crucial that SPVs cannot be brought into an insolvency proceeding of another person. With other features, this is often called "separateness" or "bankruptcy remoteness". Separateness / bankruptcy remoteness is a requirement of the European Central Bank for SPV bonds to be eligible as collateral. It is also good practice for bondholders as they usually want the SPV not to be controlled by the originator.

For example, if a bank securitised assets and the shares in the SPV were held by the bank or one of its group companies, the SPV and its assets could be brought into the insolvency of the bank. This would undermine one of the main objectives of the securitisation which is to enable investors to lend against assets independent of the credit quality of the bank. Also a bondholder would not want the bank to control the SPV as they want to lend to independent entities.

Could the SPV achieve the same objective in a different way?

Any person can become insolvent if it is unable to pay its debts as they fall due. Accordingly, shares in an SPV could not be held on trust for a person as, if that person became insolvent, the separateness or bankruptcy remoteness of the SPV would be compromised. Under Irish law, with one exception, assets must ultimately be owned by a person (individual or company); they cannot be held on trust for a purpose. The sole exception to this under Irish law is that assets may be held on trust for charitable purposes. Since the charitable trust is not held for the benefit of a particular person and is usually prohibited from incurring any liabilities, SPVs, whose shares are held on trust for charitable purposes, are usually regarded as bankruptcy remote.

Does charitable status confer any tax benefits on the SPV or the bondholders?

No