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Securitisation and other techniques of credit risk transfer

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Abstract

Firstly, the concept of credit risk will be briefly explained. This is followed by a general survey and classification of the different techniques available for the transfer of credit risk. The paper focuses on the capital market products and more precisely on the technique of securitisation. For a good understanding of the technique, we will elaborate the basic scheme and provide a concise overview of the use and the different types of securitisation.

In the second part the emphasis is put on the application of securitisation as a tool for the transfer of credit risk. We will explore the legal and accounting requirements which have to be met for that purpose. The characteristics of the Special Purpose Entity as well as the 'true sale' concept hold the limelight in this research. We will also briefly explore the principles of the different Generally Accepted Accounting Standards, with special attention to the IFRS.

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Starting point: credit risk

Credit risk is the cornerstone of the research. Credit risk is often mentioned but rather uncommonly defined. We understand credit risk as the loss resulting from the failure or the unwillingness of counterparties or debtors to fulfil their obligations as they fall due[1]. Thereby it is not relevant whether the obligations are incorporated in a security or an agreement. Every obligation or debt instrument[2] exposes the creditor or holder to a number of risks, among which the credit risk is the most important risk[3].

Credit risk encloses three components and arises each time when a period passes by between the closing and the execution of the obligation:

a) The *default risk* refers to the situation where the debtor delays or misses a payment that has fallen due[4]. The exact cause of the default has no significance because both the impossibility and the unwillingness to pay constitute a default.

b) The *rating downgrade*[5]. Listed companies and exchange traded debt securities (f.i. a bond) are commonly assigned a credit rating by a credit rating agency[6]. The credit rating is a formal indication of the creditworthiness of the issuer or the financial instrument. Each credit rating agency uses its own methodology and scale. Credit ratings are frequently reassessed. Hence, the deterioration of the creditworthiness of the issuer may cause a downgrade of his creditworthiness on the issuers scale[7]. The better the bond's credit rating, the lower the interest the issuer will have to pay to the bond investors since the interest comprises a compensation for the credit risk exposure of the bond investors.

c) The *credit spread risk*. The credit spread is a quantitative expression of the credit risk, that is calculated by comparing the Yield-To-Maturity (hereafter 'YTM') of a corporate bond with the YTM of a bond issued by an industrialised nation with the same maturity and

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[1] M. CHOUDHRY, "Credit Derivatives", in F. FABOZZI (ed.), *The handbook of financial instruments,* Hoboken, John Wiley & Sons, Inc., 2002, 785; H. BYSTRÖM, "Credit default swaps and equity prices: the iTraxx cds index market"*, Department of Economics, Lund University, Sweden – working paper*, available on http://www.nek.lu.se/publications/workpap/Papers/WP05_24.pdf, 1.

[2] Bonds, commercial paper, receivables, loans, medium term notes.

[3] Other risks related to bonds or obligations are interest risk, liquidity risk, market risk and currency risk.

[4] S. KEENAN, "Historical default rates of corporate bond issues, 1920 – 1999", *Moody's Investors Services Global Credit Research*, 2000, available on http://www.moodyskmv.com/research/whitepaper/52453.pdf, 9.

[5] J. FONS, "Understanding Moody's Corporate Bond Ratings and Rating Process", Moody's Investors Service Global Credit Research, available on http://www.moodysasia.com/SHPTContent.ashx?source=StaticContent/Free%20Pages/MDCS/Asia/Corporate%20Bond%20Ratings%20and%20Rating%20Process.pdf

[6] F.i. Moody's, Fitch Rating, Standard & Poor's

[7] J. GOH and L. EDERINGTON, "Is a bond-rating downgrade bad news, good news or no news for stockholders?", *Journal of finance*, 1993, 2007.

currency[8]. The government bonds are assumed to be free of credit risk, whereas this is certainly not the case with the corporate bonds. The difference between the YTMs is called the credit spread and reflects the credit risk premium for the corporate bond investors[9].

The credit rating and the credit spread are the foundations of new financial products, the so-called, "*credit risk products*"[10]. These products have been a catalyst for the recognition and pricing of credit risk as an independent risk[11].

Techniques for the transfer and/or the mitigation of credit risk are not new and exist for several years. Known techniques[12] are: the sale of an asset (loan, receivable or bond), credit insurance, syndicated loans, asset swaps, factoring, etc. Some techniques entail a complete run-down of the credit risk, while other techniques only serve the purpose of risk mitigation, leaving the creditor with a fraction of the initial credit risk.

A rather new credit risk product, is the securitisation. The technique was developed in the United Sates in the seventies and was applied in Europe and in Belgium in the early nineties. Securitisation is the starting point of this PhD project. Despite the fact that securitisation exists for many years, we will point out that it still gives rise to important legal and accounting issues.

Approach of the PhD project

The following questions are the starting point of the PhD. Is securitisation under certain conditions eligible as a technique for the transfer of credit risk? Which conditions have to be fulfilled for that purpose? Does the application of securitisation as a technique for the transfer of credit risk give rise to new risks and perils?

The actual research starts with the definition of two important concepts: credit risk and securitisation. Whereas the definition of credit risk didn't give rise to any problems, things are different for the second concept. A profound study of the academic and financial literature revealed that the term securitisation is often used to specify a wide variety of transactions,

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8 O. MASTROENEI, "Pfandbrief-style products in Europe", *BIS Papers NO* 5, http://www.bis.org/publ/bppdf/bispap05b.pdf, p. 44; G. DUFEY and F. REHM, "An introduction to credit derivatives", *Ross School of Business – Working Paper,* 2000, available on http://hdl.handle.net/2027.42/35581, 5; L. WEBBER and R. CHURM, "Decomposing corporate bond spreads", *Bank of England Quarterly Bulletin*, 2007, 533.

9 J. BATTEN and W. HOGAN, "A perspective on credit derivatives", *International Review of Financial Analysis*, 2002, 257; J. KRAINER, "What determines the credit spread?", *FRBSF Economic Letter*, 2004, number 2004-36, available on http://www.frbsf.org/publications/economics/letter/2004/el2004-36.pdf, 1.

10 E.g. credit insurance, credit default swaps, credit spread options, credit linked notes

11 G. DELIANEDIS and R. GESKE, "The components of corporate credit spreads", *Anderson graduate school of finance paper*, 2001, available on http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1025&context=anderson/fin, 1; A. JOBST, "A primer on structured finance", *Journal of derivatives and hedge funds*, vol. 13, no. 2, 202-203.

12 D. EFFENBERGER, "Credit derivatives: implications for the credit markets", Deutsche Bank Research, *Frankfurt voice*, July 2003, p. 5.

which do not all entail a transfer of credit risk. This finding both requires an analysis of the characteristics of a securitisation transaction as well as a limitation of the scope of the research to securitisation programs that really affect the credit risk exposure. Subsequently we make an inventory of (i) the requirements which have to be fulfilled to realise a credit risk transfer by means of a securitisation and (ii) the attached risks and perils.

The securitisation transaction

The background: the 'originate and distribute' business model

The business cycle of a credit institution consists of the collection of deposits, which are later used to originate loans[13]. The balance sheet of the credit institution acts as a transformation device between the numerous short-term deposits (the liabilities) and the long-term loans (the assets)[14]. It's clear that the loans are funded by the deposits.

The funding is the bottleneck of the (loan) origination process because:

a) the savers can easily withdraw their deposits, which will oblige the credit institution to seek for new sources of funding;
b) the loans are illiquid assets, which cannot be converted into cash before they mature;
c) the business cycle will come to a stop each time the credit institution fails to collect additional funding.

In a securitisation transaction the credit institution (hereafter 'the Originator' or 'the Transferor') transfers/sells a portfolio of loans to a Special Purpose Entity (hereafter 'SPE'), which pays cash in exchange. The SPE collects the necessary cash by issuing debt securities to investors[15]. The transaction has a fundamental and favourable impact on the credit institution's balance sheet because liquid cash takes the place of the illiquid long-term hold-to-maturity loans[16]. The received cash is the commodity for the origination of additional loans.

The SPE is an entity, which has been established with the sole view of performing the securitisation transaction. With the exception of issuing debt securities and buying the loan portfolio[17], the SPE doesn't undertake any other economic activity. Besides the loan portfolio and the debt securities the SPE hasn't any other significant assets or liabilities on the balance sheet. The repayment of the debt securities is performed by the SPE with the received

[13] G. SCHRANS and R. STEENNOT, *Algemeen deel van het financieel recht*, Antwerp – Groningen – Oxford, Intersentia, 2003, p. 378, no. 452; B. SCHOLTENS and D. VAN WENSVEEN, *The theory of financial intermediation An essay on what it does (not) explain*, SUERF, Vienna, 2003, p. 18.
[14] B. SCHOLTENS and D. VAN WENSVEEN, *The theory of financial intermediation An essay on what it does (not) explain*, SUERF, Vienna, 2003, p. 18.
[15] I. PEETERS, "Het Belgisch wettelijk kader voor effectisering van schuldvorderingen", *Bank Fin* 1994, 473.
[16] K. MACOURS, "Effectisering vanuit een bancair perspectief", *Bank Fin*, 2002, no. 15 – 17; F. FABOZZI and V. KOTHARI, "Securitisation: the tool of financial transformation", *Yale ICF Working paper,* 2007, 7, available on http://ssrn.com/abstract=997070, p. 11.
[17] J. DEACON, *Global securitisation and CDO's*, J. Wiley & Sons, Chichester, 2004, 1.

principal and interest payments of the loans[18]. This implies immediately that the holders of the debt securities (the investors) are exposed to the credit risk generated by the portfolio of loans.

In this brief (and simplified) securitisation example the three listed problems with regard to the funding of the credit institution have been resolved.

Definition and structural components of a securitisation

Securitisation[19] is a technique by which the Originator of financial assets transfers/sells a homogenous pool of assets[20] by means of a '*true sale*' to a special purpose entity (SPE). This vehicle finances the acquisition of the assets through the emission of bonds, notes or other (hybrid) financial debt instruments.

The transfer of the assets to the SPE isolates the loan portfolio from the claims of the creditors of the credit institution. The debt security investors are the SPE's only creditors[21] and are in case of insolvency of the SPE fully and alone entitled to the proceeds of the loan portfolio[22]. This results from the acquisition of the ownership of the loan portfolio by the SPE and also from the limited scope of the economic activities carried out by the SPE[23]. The credit institution creditors' are in principle thus no longer entitled to the transferred portfolio or exposed to the related risks.

The debt securities investors are not only protected by asset isolation. To mitigate the credit risk of the investors, usually one or more of the following credit enhancement techniques are put in place.

Tranching

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[18] P. GORIS, "De effectisering in internationaal perspectief", in D. MEULEMANS (ed.), *Effectisering*, Brugge, Die Keure, 1995, 277-278.

[19] C. JANSSENS, *De techniek van het effectiseren en toepassing op de Belgische markt*, De Boeck & Larcier, 2003, 5; K. MACOURS, "Effectisering vanuit een bancair perspectief", *Bank Fin* 2002, no. 3; H. DETREMMERIE, "Effectisering van activa: hoe kan dit in België worden geregeld?", *Bank Fin* 1994, 465; GBRW, "Study on asset-backed securities: impact and use of ABS on SME finance", 2004, available on http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/report_en.pdf, 1; A. JOBST, "A primer on structured finance", *Journal of derivatives and hedge funds*, 2007, no. 3, p. 201

[20] DWIGHT ASSET MANAGEMENT COMPANY, "Fixed income primer: asset-backed securities", 2005, 1

[21] V. KOTHARI, "Back on to the balance sheet: the future face of securitisation", available on http://www.vinodkothari.com/The%20Future%20Face%20of%20Securitisation%20Viinod%20kothari.pdf, s.d., p. 1.

[22] F. FABOZZI and V. KOTHARI, "Securitisation: the tool of financial transformation", *Yale ICF Working paper,* 2007, 7, p. 4 available on http://ssrn.com/abstract=997070.

[23] F. FABOZZI and V. KOTHARI, "Securitisation: the tool of financial transformation", *Yale ICF Working Paper,* 2007, 7, p. 5.

The SPE issues debt securities in a number of different categories (e.g. A until D). Each category has a different ranking in the receipt of the incoming principal and interests payments which the SPE receives on the loan portfolio[24]. To put it concretely: the incoming cash flow of the SPE will firstly be used to repay the holders of the securities with the highest ranking (the A securities). The holders of the subordinated B securities will only receive payment after the holders of the A securities. The same goes mutatis mutandis for the holders of the subordinated C and D securities. The A-class securities are called the senior tranches and carry the lowest level of credit risk, while the holders of the D-class securities, the so-called junior tranche, bear the highest exposure to the credit risk[25]. The junior tranche is often retained by Originator[26], by which a part of the transferred credit risk flows back to him.

The SPE will solicit a Credit Rating Agency to assign a credit rating to the various tranches. The more senior tranches will of course receive a better rating than the lower mezzanine and junior tranches. The level of credit risk and the credit rating is reflected in the amount of interest that the holder of a particular tranche receives. The higher the level of credit risk, the higher the risk premium (credit spread) for the investor.

Excess spread

To be able to repay the investors, the incoming cash flows of the SPE have to match at least the outgoing cash flows. The SPE is able to calculate the correct amount of its liabilities to the investors and thus to determine the required amount of underlying loans to generate a sufficient incoming cash flow. The excess spread is the positive difference between the incoming and outgoing cash flows of the SPE[27]. The excess is deposited into an account of the SPE ('the spread account') and can be used for different purposes among which credit enhancement.

The excess spread serves as an additional protection for the holders of the debt securities because in case of a default of one or more debtors of the underlying loans, the decrease in the incoming cash flows won't immediately impede the SPE to timely repay its investors. Indeed, the first credit losses caused by defaults in the underlying portfolio are absorbed by the available excess spread. The level of protection depends on the amount of the excess spread.

The excess spread is the cheapest type of credit enhancement, because it is composed of the incoming cash flows generated by the underlying assets. However, the use of the excess spread as credit enhancement has the disadvantage that there isn't much credit enhancement available at the inception of the transaction. At the end of the securitisation the available excess spread usually accrues to the Originator. In this way the Originator obtains again exposure to the transferred credit risk.

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[24] F. FABOZI and V. KOTHARI, "Securitisation: the tool of financial transformation", *Yale ICF Working Paper,* 2007, 7, p. 2.

[25] GBRW, "Study on asset-backed securities: impact and use of ABS on SME finance", 2000, available on http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/report_en.pdf, 74.

[26] GBRW, "Study on asset-backed securities: impact and use of ABS on SME finance", 2000, available on http://ec.europa.eu/enterprise/entrepreneurship/financing/docs/report_en.pdf, 3.

[27] J. NORTON, *International asset securitisation*, London, Lloyd's of London press, 1995, 16-17;

Cash collateral

The use of cash collateral is quite similar to the excess spread as both consist of an account with cash. The difference between the excess spread and the cash collateral lies in the source of the cash. While the excess spread is built up of the incoming cash flows of the SPE, the cash collateral account is funded by a subordinated loan granted by the Originator or a credit institution[28]. The cash collateral offers a better protection than the excess spread because it is available at the inception of the securitisation program[29]. Whether the grantor of the subordinated loan will receive a full repayment at the end of the program depends on the volume of the credit losses suffered by the SPE. It's clear that in cases where the Originator grants the loan a part of the transferred credit risk flows back to him.

Overcollateralization

Overcollateralization is the credit enhancement technique whereby the nominal value of the loan portfolio is higher than the nominal value of the issued debt securities[30]. The overcollateralization is usually put in place through the fact that assets of the loan portfolio are sold to the SPE under their fair value. As usual, the amount of overcollateralization that hasn't been used to offset credit losses within the asset pool of the SPE, will be returned to the Originator, who is again exposed to credit losses.

Credit insurance and guarantees

These techniques both consist of an engagement of a (third) party to reimburse the SPE for the losses suffered by the materialisation of credit risk[31]. In most cases the amount of the protection is limited. In cases where the protection is provided by the Originator, there is clearly a return of the transferred credit risk.

The distinction between on- and off-balance sheet securitisation

A securitisation program is made up of two components: (i) the funding of the SPE, which is effected by the issuance of debt securities by the SPE and (ii) the transfer of the funding to the Originator. The second step can be configured in two different ways.

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[28] K. MACOURS, "Effectisering vanuit bancair perspectief", *Bank. Fin.*, 2002, no. 3.
[29] DWIGHT, "Fixed income primer: asset-backed securities", 2006, available on http://www.dwight.com/pubs/dwightABS2005.pdf, 6.
[30] A. UGUR and H. ERKUS, "Securitisation: a basic finance tool of financing for the firms", available on www.esosder.org, 2007, C.6, S.22, 240
[31] R.B. BREWER and L.S. ISELEY, "Credit enhancement for asset-backed securities", in J. LEDERMAN (ed.), *The handbook of asset-backed securities"*, New York, Institute of finance, 1990, 127 – 139; P. WOOD, *Title finance, derivatives, securitisations, set-off and netting*, 1995, 58.

Firstly, the SPE can *buy* assets from the Originator and pay cash as a transfer price[32]. Secondly, the SPE can *lend* the collected cash to the Originator[33]. In the last case, the ownership of the assets remains with the Originator[34], who will normally have to pledge the assets in behalf of the SPE and/or its investors[35].

The above described transaction, is a so-called '*true sale*' securitisation, where the SPE transfers the cash to the Originator by means of a sale. The Originator's aim of such a transaction is to remove the asset (the loan portfolio) and the corresponding liability (the financing – funding) off the balance sheet.

To achieve these two goals the following cumulative requirements have to be fulfilled[36]:

(i) the assets (loan portfolio) are sold to the SPE;
(ii) in pursuance of the sale, the assets are in accordance with the applicable accounting standards derecognized by the originator and recognized by the SPE;
(iii) the applicable accounting standards don't constrain the Originator to consolidate the SPE as a subsidiary.

The second requirement is closely linked to the first condition because the general accepted accounting frameworks[37] both prescribe that a derecognition of the assets is only allowed as a consequence of a true sale, that results in the isolation of the assets on the balance of the SPE[38]. The third prerequisite on the other hand holds a complete autonomous position, which is expressed by the divergence between the accounting rules of US GAAP and IFRS regarding to consolidation.

Each time when the three foregoing conditions aren't met the securitisation program will not qualify for off-balance sheet treatment. In most cases the lack of a true sale is the sticking point. Against this particular background it's not always relevant whether the securitisation legally has to be considered as a sale because the accounting principles are applied to the economic substance. It's often the case that a transfer of assets which is legally pretended to be a true sale, has to be treated according to the prevailing accounting principles as a secured lending. As a consequence the Originator won't be able to derecognize the loan portfolio and the transaction will have to be reported on the balance sheet of the Originator.

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[32] J. HENDERSON and J. SCOTT, *Securitisation,* Cambridge, Woodhead – Faulkner, 1988, 32.
[33] O. MASTROENI, "Pfandbrief-style products in Europe", *Bis Paper No 5,* available on http://www.bis.org/publ/bppdf/bispap05b.pdf, p. 46.
[34] [34] T. GRANIER and C. JAFFEUX, *La titrisation, aspects juridique et financier*, Economica, Paris, 2004, p. 19
[35] N. MEISNER, "The market for covered bonds in Europe", *Deutsche Bank Global Markets* Research, 2003, available on http://pfandbriefverband.info/d/internet.nsf/0/CA48735357A27B24C12571E9003778AD/$FILE/eur_li_lued_meisner_covered_bonds.pdf, p. 6.
[36] P. JEFFREY, "International harmonization of accounting standards, and the question of off-balance sheet treatment", *Duke Journal of Comparative & International Law,* 2002, vol. 12, 341– 351.
[37] IFRS and USGAAP
[38] Financial Accounting Standards Board, *"Statement of Financial Accounting Standards No. 140, Accounting for transfers and servicing of financial assets and extinguishments of liabilities",* Implementation Guidance, available on http://www.fasb.org/pdf/aop_FAS140.pdf, 2000, no. 27-28.

The accounting of an *on-balance* securitisation transaction is effected as follows. The SPE will

(i) derecognize the cash (an asset) which is lent to the Originator
(ii) recognize a claim (an asset) against the Originator for the repayment of the loan

The Originator at his turn will:

(i) recognize the received cash as an asset;
(ii) recognize a new liability for the repayment of the loan;
(iii) keep the loan portfolio on the balance sheet;
(iv) (pledge the loan portfolio to the SPE or the investors.)

The fact that the credit sensitive assets (the loan portfolio) remain on the balance sheet of the Originator implies that the Originator and not the SPE keeps bearing all the credit risk[39]. We can conclude that the on-balance sheet transactions are therefore only suitable for funding[40] purposes, while off-balance operations serve the purpose of funding as well as credit risk transfer.

The legal position of the debt securities investors

We found that an off-balance securitisation, in contrast with an on-balance transaction, shifts credit risk to the SPE and consequently its investors. This conclusion has great significance for the investors.

Let us assume that the loan portfolio fully dilutes due to the realization of credit risk. In case of the off-balance sheet securitisation all the assets of the SPE are swept away with the outcome for the investors that they won't receive any payment if no external credit enhancement has been put in place. Indeed, the credit risk is being absorbed by the SPE and its investors. The debt securities issued in an off-balance securitisation program are denominated Asset Backed Securities (ABS).

In the case of the on-balance sheet transaction the loss is taken by the Originator, which is obliged to repay the loan to the SPE notwithstanding the realization of the credit risk. The Originator will repay the loan with other assets and the SPE investors won't suffer any loss as the technique of the secured lending provides the SPE investors with a full recourse to all the assets[41] of the Originator. As mentioned above, the Originator will also pledge some assets (the loan portfolio) in favor of the SPE and its investors. In this way, the SPE disposes of a double recourse and even becomes a preferential creditor of the Originator.

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[39] R. GROSSMANN and O. STÖCKER, "Overview of covered bonds", in ECBC, "European covered bond fact book", 2008, available on http://ecbc.hypo.org/Content/Default.asp?PageID=367, p.51.

[40] R. BURMEISTER, F. RUDOLF, C. SIGL and F. WILL, "Covered bonds as a funding tool", in ECBC, "European covered bond fact book", 2008, available on http://ecbc.hypo.org/Content/Default.asp?PageID=367, p. 24.

[41] A. POULAIN, "European structured covered bonds: Moody" rating approach", *Moody's Investors Service*, 2003, 1, available on http://ec.europa.eu/internal_market/bank/docs/regcapital/realestate/200307-comments/moodys%20rating%20approach_en.pdf.

Almost all the European countries (with the exception of Belgium) have a legal framework that allows the emission of covered bonds. The incentive for the creation of a framework lies in the UCITS and CRD directives[42]. The covered bonds offer many advantages: they qualify as Tier I collateral[43] in transactions with the European Central Bank and receive an advantageous regulatory capital weighing under the Capital Requirements Directives[44] compared to the regime of Basle II.

The credit crunch revealed that the presence of a covered bond framework has been appreciated by the markets. While the ABS markets became illiquid in the summer of 2008, the covered bonds markets kept functioning[45]. In the same period both the spreads of the ABS and the covered bonds raised, but the spreads of the covered bonds remained significantly lower than the ABS spreads[46].

Risks and problems regarding to securitisation transaction

Recharacterisation risk

The overview of the structural aspects of a true sale securitisation pointed out that notwithstanding the – pretended - '*true sale*' of the loan portfolio to the SPE, the seller stays involved. The servicing of the assets, the retention of the junior tranche and the supply of credit enhancement expose the Originator to the gains and losses caused by the transferred assets. More than once this finding raised the question whether a true sale has taken place because a sale normally entails that the seller is no longer exposed to the possible losses of the sold assets and that the buyer (and not the seller) is entitled to the gains of the sold assets.

On the basis of the forgoing findings some transactions based on a true sale were recharacterised by the US courts as secured lendings[47]. The recharacterisation risk is not

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[42] Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), *O.J.L.* 31 December 1985, 375.

[43] N . MEISNER, "The market for covered bonds in Europe", *Deutsche Bank Global Markets Research*, 2003, available on http://pfandbriefverband.info/d/internet.nsf/0/CA48735357A27B24C12571E9003778AD/$FILE/eur_li_lued_meisner_covered_bonds.pdf, p. 9.

[44] Directive 2006/48/EC of the European parliament and of the council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, *O.J.L.* 30 June 2006, 177; Directive 2006/49/EC of the European parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions, *O.J.L.* 30 June 2006, 177/201.

[45] R. BURMEISTER, F. RUDOLF, C. SIGL and F. WILL, "Covered bonds as a funding tool", in ECBC, "European covered bond fact book", 2008, available on http://ecbc.hypo.org/Content/Default.asp?PageID=367, p. 26; R. GROSSMANN and O. STÖCKER, "Overview of covered bonds", in ECBC, "European covered bond fact book", 2008, available on http://ecbc.hypo.org/Content/Default.asp?PageID=367, p.51.

[46] R. BURMEISTER, F. RUDOLF, C. SIGL and F. WILL, "Covered bonds as a funding tool", in ECBC, "European covered bond fact book", 2008, available on http://ecbc.hypo.org/Content/Default.asp?PageID=367, p. 24 and 32.

[47] AICHER and FELLERHOFF, "Characterization of a transfers of receivables as a sale or a secured loan upon bankruptcy of the transferor", *Am. Bankr. L. J.* , 1991, 181; J. KRAVITT, *Securitisation of financial assets*, Aspen Law & Business Publishers, 5-56.12; The Woodson Company, 813 F.2d

limited to securitisation transactions, but is also associated with other transactions which are based on a sale mechanism such as a repo or a sale and lease back.

The recharacterisation risk has far reaching consequences for the position of the creditors of the SPE and the Originator. If the transaction is considered to be a secured lending, the assets will be a part of the bankruptcy estate of the Originator and serve at least theoretically as a mutual collateral for all the creditors of the Originator. Consequently the recharacterisation procedures are often initiated by the Originator's creditors.

Accounting practice

At this moment two major General Accepted Accounting Practices (GAAP's) exist: IFRS is applied in the EU[48] and some other countries, while US GAAP is applicable in the US.

Firstly, the accounting principles contain the rules related to the recognition and derecognition[49] of assets and liabilities. The frameworks contain detailed guidance with regard to the qualification of the transfer mechanism as a sale or a secured lending. The classification is based on multiple criteria such as:
(i) have the assets been transferred?
(ii) have the rights to the cash flows generated by the assets been transferred?
(iii) has the Originator retained or transferred all or a part of the risks related to the assets?
(iv) who has the control[50] over the assets?

Secondly, the accounting principles related to consolidation also play an important role since the effect of the derecogniton of the assets by the Originator will be neutralized when the Originator has to consolidate the SPE which has acquired and recognised the transferred assets[51]. This illustrates that the accounting rules have a great influence on the possibility to transfer credit risk off the balance sheet.

A comparison of the IFRS[52] rules with the principles of US GAAP seems to indicate that it is not possible to establish a non consolidated SPE under IFRS. US GAAP on the other hand

266, 271 (9th Cir. 1987), available on http://bulk.resource.org/courts.gov/c/F2/813/813.F2d.266.85-2714.85-2698.html; Major's Furniture Mart Inc. v. Castle Credit Corp. 602 F.2d 538, 544 (3d Cir. 1979); CF Motor Freight v. Schwartz, 215, B.R., 947 (Bankr. E.D. Pa. 1997); Fireman's Fund Ins. V. Grover, 813 F.rd 266, 251-272 (9th Cir. 1987); National Discount Co v. Evans, 272 F. 570, 573-74 (6th Cir. 1921); Ryan v. Zinker, 164 B.R. 224 (Bankr. E.D.NY. 1994); Rechnitzer v. Boyd, 40 B.R. 417, 422 (Bankr. C.D. CAL 1984); Castle Rock Indus. Bank v. S.O.A.W. Enters, 32 B.R. 279, 282 (Bankr. W.D. Tex 1983)

[48] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards *O.J. L* 243, 11 September 2002, 1-4.
[49] IFRS: IAS 39; USGAAP: SFAS 140
[50] The control commonly refers to the power to sell or pledge the assets. If the SPE is supposed to have acquired the full ownership of the assets, it should be entitled to sale and/or pledge them. Sometimes the Originator has a call option to buy back the transferred assets, which prohibits the SPE to sell or pledge the assets.
[51] IFRS: IAS 27 and SIC 12; USGAAP: ARB 51and FIN 46(R)
[52] IAS 27 and SIC-12

provides an exemption to the consolidation rules for some SPE's (the so-called Qualifying Special Purpose Entities) resulting in off-balance securitisations.

New American accounting standards[53] issued 12th June 2009 impose significant changes to the field of securitisation accounting and it is likely that they introduce the end of off-balance sheet accounting in the US. The new accounting regime may require a rethinking of the Asset Backed Securities and the off-balance sheet securitisation. To be continued…

Conclusions

The notion securitisation is used to denominate a wide variety of transactions, but only a restricted a limited number of them is usable to set up a transfer of credit risk.

Credit risk can only be transferred when the securitisation program meets (i) the accounting requirements for an off-balance sheet transaction and (ii) the Originator sells the transferred assets to the SPE.

With regard to the first prerequisite it must be said that up till now significant discordances exist between USGAAP and IFRS in the field of the consolidation of SPE's with the result that it seems quite difficult to construct an off-balance securitisation under IFRS while USGAAP - at least until recently - offered a clear possibility to avoid the consolidation of the SPE with the Originator.

As concerns the second requirement, the borderlines between a secured lending and a true sale are not clear. In practice a securitisation transaction will always have properties of the two 'transfer' mechanisms owing to the continued involvement, which gives rise to a recharacterisation risk.

[53] FAS 166 and FAS 167

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