Chapter 3 General Environment for Securitization in Taiwan

3.1 Legal Environment and Tax Treatment

3.1.1 Financial Asset Securitization Regulations

The nasty competition between banks and within the whole banking industry provoked trends of merger and acquisition together with financial innovation races and also attracted efforts from government authorities trying to improve the quality of domestic financial institutions by building a fair and well-monitored arena for all players. Not only the situation that domestic companies competing to each other disturbed hardly maintained orders, one more serious problem is the invincible foreign companies and far more competitive products makes profitability of domestic companies further deteriorate.

Requests for regulations and liberalization of financial innovations and derivatives keep coming from bankers, security traders, scholars, and even semi-government officers. Bureau of monetary affairs called a group of experts of several different fields to go through a complete research of every details of securitization and completed the first edition draft of financial asset securitization regulation.

The first draft referenced securitization laws in Japan and other developed countries. For simplicity concern, this edition excluded special purpose company (SPC) structure and make special purpose trust (SPT) the only special purpose vehicle to hold collateral, separate bankruptcy risk, and issue securities. First draft was not been approved as expected and current securitization regulation came from second draft which reunited SPC into structure. This critical step is a historical event, started a whole new era of banking industry and created a wonderful dream among all participants in this market.

Principal Focus and General Rules

Financial asset securitization regulations has 119 sections divided into 7 chapters which are general rules, special purpose trust, special purpose company, credit rating and credit enhancement, supervision, penalties, and subsidiary. This fundamental regulation consolidated the legal structure of securitization transactions,

dissolved legislative barriers, clarified tax issues, and confirmed government agency's regulatory responsibilities. Although the whole structure of securitization embedded in the regulation is almost the same as it is in the U.S. or Japan, some legal definitions and requirements, documentation necessities, application rules, and administration procedures are quite different in this MIT securitizaiton law.

One good example would be the complexity of different jurisdictions of various financial affairs and it usually is not easy to know exactly who is in charge of explaining and approving under such a bureaucracy even if there is a seemly clear rules and seemly time reducing single window function. Without knowing some "inside information" and getting official communication techniques, many should-be-simple tasks and routines will become unbelievably tedious. The researcher picked some key issues every issuer would like to consider thoroughly before applying and releasing any products and diagnosed these subjects and ended the chapter by listening to major players in securitization.

One thing that we should make clear before we go on is the jurisdiction of monetary affairs. The primary administrator of banking industry in Taiwan is Bureau of monetary affairs (BOMA) which governed most banking related affairs and activities and also was responsible for securitization affairs administration. However, foreign exchange affairs are governed by central bank of Taiwan and securities related business is monitored by Securities and Futures Committee (SFC).

As for securitization, general approval authority is BOMA who takes opinions from both central bank of Taiwan and SFC and depends on explanations from tax agency and Ministry of Interior Affairs when examining cases. Other possible governments or governmental agencies that will involve in a securitization transaction are local governments, all kinds of government funds, regulatory agencies of government funds, and possibly, the highest level of government which the researcher believe is definitely a special case in Taiwan.

Originator

Originators are financial institutions or other qualified institutions which transfer financial asset to a SPT or SPC in order that special purpose entity could issue securities supported by the underlying collateral. Financial institutions means: First, banking act defined banks and credit card business institutions and the act governing bills finance business defined bills finance corporations; second, insurance act defined insurance companies; third, securities and exchange law defined securities companies; fourth, other financial institutions approved by authority as qualified originators.

Under this definition, not only financial institutions but other entities such as manufacturing companies, local governments, and associations can securitize assets with stable cash flows to improve asset management efficiency and overall cost of capital. We expect early stage originators will be limited to financial institutions due to market immaturity and unfamiliarity of potential originators and cooperation with foreign investment banks or securities companies is a necessary resort for technology transferring.

Collateral Assets

Current regulation defined specific asset types for securitization and those securitizable assets are: automobile loans and other chattel mortgages, real estate mortgages, leases, credit card receivables, other monetary receivables, trust beneficiary rights, and other authority approved receivables. In other words, it excluded other non-receivable like assets which also create stable cash flows such as copy rights or box office revenues. This narrow structure might give rise to the future legal revision and conceivable bottleneck of financial innovations.

Special Purpose Trust

The main structures of special purpose entity defined by the regulation are both special purpose trust (SPT) and special purpose company (SPC). Although the regulation mainly referenced to legal documents and rules in the U.S. and Japan, the legal structure and explanations of securitization transactions are differing from the origins. Some research papers had treated this structure as SPT for pass-through securities and SPC for pay-through securities as they were in the U.S. which is not correct at all. Current transactions are structured under SPT and all of these 6 products had pay-through characteristics. What we have seen on the market motivated the researcher to further clarify the true contents and meanings in this newly introduced regulation.

SPT is defined as the trust relationships of which started up for securitization purpose only and fully complied with the regulation. Certain qualifications are prerequisites for both trustors and trustees. Trustors are originators who complied with the definition we had in originator section. Trustees have to be qualified trust institutions governed in the Trust Enterprise Act with investment grade credit ratings received from approved credit rating agencies which are Standard and Poor’s, Moody’s Investors’ Services, Fitch Ratings, and Taiwan Ratings Corporation. The special purpose and functions trustees had makes monitoring and supervising trust

institutions really crucial for the whole collective trust system to work smoothly that several other requirements and restrictions derived from this specialty.

First, trustees cannot be subsidiaries, related enterprises, or mutually invested entities which are defined in article 369 of company act of originators. The definition of related enterprises is not limited to superior equity holding basis but broadly applied to any entities of which finance, personnel affaires and management are controlled by parent company. This could achieve the true transition and isolation of collaterals and guarantee the safety of investors' interest at the same time prevented legal ambiguities and any potential illegal fraud could happen in the other way.

Second, any transaction have to make a detail securitization plan, trust contract, collateral management and hedging plans, and other required documents. The regulation listed specific requirements and forms for those applications documents such as the purpose, trustees' obligation, the calculation and delivery of trustees' rewards, management and execution of trusted assets, the disposition of interests and other yields generated from trusted assets, the issuance formation, and limits on transition of securities, etc, to guide market players. Enforcement rules and guidelines for prospectus documentation are released to further specify the disclosure obligation of the originators and trustees and this is a critical step for this newly introduced product and unacquainted market to stand steady and be accepted by participants in the future.

Third, sources and uses of money are strictly confined. Financing guaranteed by trusted assets is prohibited unless prior documented in securitization plans and the uses of borrowed money are limited to release dividends and interests or other yields only. Extra cash can only be put into deposits, government or financial bonds, treasury bills or NCDs, and commercial papers with investment grade ratings. Some people criticize this restriction will reduce servicer's flexibility and liquidity that could cause more serious consequences as financial distress and unable to serve obligations promptly and completely.

Worries like these are not issues because credit enhancements of securitization transactions and liquidity providers some transactions may have can provide liquidity needed during the whole duration. Financial distress or early amortization will occur under circumstances like deteriorated collateral quality, overall interest level volatility, or servicer insolvency all of which have nothing to do with the uses of extra cash. In the contrary, without this restriction, it is highly possible that some managers and trustees will use extra cash or borrow money to tab into blooming stock market to capture excess profits in the cost of all beneficiaries.

Bureau of monetary affairs concerned about any disorders or stumbles could happen during the early stage of securitization and planted one more defense of unexpected risks that is beneficiary convention assigned trust supervisors to enhance the supervisory mechanism embedded in the structure. Supervisors can act on the behave of all beneficiaries to file a lawsuit or other legal actions to protect assets from deteriorating and all kinds of fraud hence further improved the quality of the security.

Special Purpose Company

Special purpose company framework is excluded from the first edition draft of financial asset securitization regulation for simplicity concern but it is added into second draft afterwards. Special purpose company is a company act as a conduit for securitization and an entity provided isolation of collateral. The application and approval procedures are quite different from those of ordinary companies with “real” business.

Under current legal environment, limited liability companies can be set once certain criteria are met and all limitations are not violated and this is called principlism. It is a different story for SPC, though. Due to the special character and functions of SPC plus market unmaturity, BOMA put strict rules and set up enforcement laws with a purpose to keep any fraud and deceit out. SPC cannot be initiated until every requirement is met, all application documents are examined by authorities, and an approval letter is released.

Basic requirements of SPC are: First, SPC can only be started by financial institutions and only one shareholder is allowed which means SPC is wholly owned by one single financial institution and only for securitization purpose. This single shareholder cannot underwrite total shares separately, cannot issue preferred shares, and cannot sell or transfer any shares of SPC without BOMA’s prior approval either.

Second, the independent feature of SPC. In some overseas cases, SPC is initiated by originator but that is not allowed in Taiwan. Article 54 of financial asset securitization regulation stated that the financial institution which started SPC cannot be related institutions of the originator. That’s for preventing any collusion such as illegal usage of collateral or running unnecessary business from occurring.

Third, the name of SPC must include the words “Special Purpose” and any other company which is not a special purpose company cannot use “Special Purpose” as part of company title. Fourth, originator has joint responsibilities with SPC for circumstances related to violations of originator’s obligation to disclosure.

Legal Effect to Debtors and Third Entities

Some prerequisites must be filled before originators and trustees can claim the legal effectiveness of a securitization transaction to debtors whose debts had been transferred and creditors of originators. There was an argument about how to define the legal effect priorities between the existing civil law and trust law and newly developed securitization regulations. On the one hand, securitization transactions can only be completed under conditions which collaterals are separated from the original owner. On the other hand, this action may cause potential damages to originator's creditors as well.

Originators must transfer or sell collaterals to SPT/SPC to get bankruptcy isolation mechanism or no one will get into this deal and there will be no transactions and market. Some participants claimed that the article 6 in trust law which regulates revocation rights of creditors of originators should be numbed to securitization deals. This idea was not accepted in concern of some despiteful companies may use securitization transaction as a method to prevent creditors from taking legal actions in a default event.

This is really a serious problem in Taiwan because so many financial institutions were hammered by NPLs and frauds years ago and haven't been recovered from those devastating losses yet. According to statistic data released by BOMA at the end of 2003, the overall rate of delinquent loans of domestic banks is 6.84%, 10.34% for credit unions, and astonishingly 18.62% for savings and loans division of farmers' association. Even years after government's tax cut proposal for healing the NPL problem took place, the overall condition of financial institution in Taiwan is still not satisfactory which may encourage more crime.

The solution provided is the compromise between two extremes. Article 5 in FASR declared the requirements of announcement procedure. Originators should announce quantity, quality, and detail content of the assets been transferred to trustees using official formats through local newspapers or other channels approved by authorities. Failing to comply with this disables originators to claim legal rights of the transaction against third parties. This mechanism protected creditors' interest and security of investors.

As for debtors, according to the Civil Law in Taiwan, lenders have to give a notice to borrowers about the transformation of their debts or the transferee cannot claim any rights over the debtors. Giving a notice to one or a few debtors is simple and just cost a few dollars, however, this is not the story of securitization.

Most securitization case involved from dozens of debtors, for example, the CLO of Taiwan Industrial Bank, to millions accounts like ordinary credit card transaction. For a case with millions of credit card customers, it is almost impossible to tell every single cardholder the content of the transferring and that will devastate all securitization cases. There are three alternatives to comply with the obligation of notice.

First, in cases where originators are servicers, simply completing the announcement obligation required by article 5 will do. Just made a public announcement with specified formats and through particular channel, and no further notification is needed to claim intact legal rights and effectiveness. For cases that servicers are not originators, one more step is needed which is sending certificates of announcement to debtors. The BOMA has released the official format for announcing debts transfer and certificate of announcement in 2002.

Another more efficient way is putting provisions of agreement of transfer and the required notification efforts in the contract at the beginning and most newly contracted debts have embedded this characteristic. However, the most cost effective resort is only available to newly constructed loans.

3.1.2 Related Issues and Explanations and Orders from Government Authority

It is not enough for securitization transaction to move on until other related rules, enforcement laws, and explanations are completed. BOMA has released necessary enforcement laws and dozens announcements to clarify every details. We'll check enforcement laws of financial assets securitization regulations, rules governing setting up SPCs, and asset backed securities listing requirements below.

Enforcement Laws of Financial Assets Securitization Regulations

There are twenty five articles governing details of securitizations structure which are not regulated in the original regulation. Half of these rules deal with comparatively minor issues such like refining definition of eligible assets for securitization to include contingent receivables. The specific conditions and terms for trust supervisors about their obligation, rewards, and meetings, etc.

The necessity of beneficiaries and security holders to declare certificates for exercising voting rights and cash yields is decided by trust contract or securitization plan. With specific description and limitation, it is a legitimate transaction which is structured with the accessibility of contingent beneficiaries who can be identified after

the completion of transaction. There are two more critical provisions in this enforcement law are the definition of trivial changes of securitization plans and hypothec transformation.

The first one is basically an anti-fraud regulation. Article six in enforcement law defined specific conditions and arena of trivial changes mentioned in FASR. Changes are trivial to security holders only if changes are: (1) made prior to any effort of initial public offering or private placement; (2) related to the early termination of SPT contract under the completion of all predetermined functions; (3) permitted by all beneficiaries; (4) made to revise documentation requirements of securitization plans, approved by lawyers due to obvious errors or misunderstandings exist.

This article prevented any frauds which may happen due to issuers/servicers' discretion of revision of securitization plans. This discretion is given to issuer/servicer for the purpose of improving efficiency and reducing cost. Issuers will have a tough time handling operation affairs without certain degree of discretion and there will be no transactions at all.

The other critical issue is the transformation of hypothecs. Most residential mortgages in Taiwan are structured with limited quota hypothecs, that is, borrowers and lenders agreed upon a predetermined quota of total lend amount. This will cause no problems in a traditional mortgage transaction. However, while securitization cases need to transfer collaterals to SPT/SPC for bankruptcy remote mechanism, transformation of hypothecs become key factors.

3.1.3 Tax Treatment

Financial institutions using SPT/SPC structure to securitize financial assets is a whole new frame of transaction that never seen in Taiwan's financial market before. The taxes involved in securitization transactions are: stamp tax, deed tax, land value increment tax, transaction tax, business tax, and income tax. Every tax has its own definition and application rules which are complex and hard to apply. The explanations of each transaction about the timing and subjects applying each rule are given on a case by case basis, so, they are highly uncertain.

At Beginning Stage

To encourage potential originators and investors, especially foreign investors, there are tax deduction mechanisms built in FASR and Ministry of Finance released orders subsequently to make tax burdens lighter. Let's go through these taxes one by

one follow the timeline of a transaction. Let's first look at taxes related to assets transfer at the time of origination. Article 38 to 41 in the FASR stated that: First, stamp tax, deed tax, and business tax generated from asset transfer except deed tax comes from execution of real properties by trustees are exempted.

Second, all administration fees of real estate registration and setting up hypothecs of real estate and other assets are exempted also. Third, for financial asset securitization, land value increment tax will occur only when hypothec is executed due to debtors default, and under that circumstance, tax paying obligation falls onto the debtors, not lenders/originators. Of course, tax agency has priority claims over the yields of execution.

After Issuance

All of the above taxes are simple, less controversial ones. Whenever deals are done, transaction tax and income tax became major issues. Referenced to regulations of other advanced countries, securities transaction tax of bond like ABSs is the same level as that of corporate bonds but this is not applied to ABSs with short-term note characteristics.

According to industry upgrade promotion regulation, transaction taxes of corporate bonds and financial bonds are exempted until 2009 which means ABS transactions in Taiwan is tax free in 5 years. However, for short-term securities like asset backed commercial paper, short-term note transaction tax is applied. Some market participants argued that transaction tax should be eliminated for both ABS and ABCP to prosper this market.

This proposal is not be accepted by authorities and debate does on. Since managing financial assets of financial institutions is part of the whole business, revenues generated from SPT acted as a trustee to hold collaterals in accordance to issue securities should be treated no difference to other revenues of the issuer and can apply to business tax level of banks (article 40).

Income Tax

The other more cumbrous and focus attracting topic is income tax which is usually the most critical one for every transaction. After long time debate and wrestling, fortunately, tax agency has released explanations tax treatment of ABSs. This issue can be split into two parts: how much the tax is and how it is charged.

Current explanation treated revenues distributed to security holders as interest income of them and excluded from enterprise income tax of trustees. The rationality behind this treatment is revenues and benefits came from collateral assets will go to beneficiaries, not the trustees, although the underlying asset didn't actually transfer to beneficiaries. Based on this point, net income generated from revenues of collaterals minus all expenses of operation and management is income of security holders.

Further more, this cash inflow is treated as interest earned by ABS holders for the reason that in most cases, the first senior class notes usually acted like fixed income notes of which yields is predetermined on prospectus and is separated from collateral performance. In a nut shell, net income distributed to ABS holders is interest income and is been taxed separately at interest income bracket.

This explanation is three fold: First, SPT/SPC is assumed to be only conduit, not business entity with real profit making business. According to that assumption, no enterprise income tax is charged and ABS holders' interest income tax total is based on the net amount of yields earned by collateral assets minus all expenses. Once being put into interest income basket, ABS holders can enjoy 270,000 NTD tax deductions.

Second, this interest income is taxed at a separate tax bracket of 6% compared with 20% for short notes, 25% for enterprise income tax, and aggressive individual up to 40 % income tax.

Third, separation from individual income and enterprise income avoided aggressive tax and made ABSs more attractive to investors in high income tax bracket. Some comments stated that this tax structure favors the riches and is not fair at all, others claimed that the 6% tax is still too high for market to grow. The researcher believes that lower than average tax is needed to push the market and benefit all market players as well as others in the society which makes arguments about fairness seems subtle.

Tax Payable Withholding

It is debated about whether or not to withhold tax payable on yields of assets held by trustees and if tax payable is withheld, can the withheld amount be used to offset income taxes thereafter? If tax payable needs to be withheld but can't be used to offset income tax, is there a double taxation problem? According to documents and opinions released from Ministry of Finance, this question can be explained as follows: Tax withholders don't have to withhold tax payable when they made a payment to trustees in a securitization transaction and the tax will be paid when trustees

distributing yields to beneficiaries in the future. They do have to withhold when the payment is interest of short-term note which is taxed at a different bracket, that is 20%, but at the time trustees send out proceeds, they don’t have to pay the tax again either.

In practice, the original debtors will not be affected by the transition of debt, that is, the withholding obligation of debtors is changed during securitization transaction. One thing different and worth noting is when banks paid interest to savings account, usually they have to withhold taxes payable but this is not the case while the account belongs to a SPT/SPC.

This explanation takes SPT/SPC as conduits between collaterals and beneficiaries, not an entity running real business, and avoids double taxation. It takes economic reality under trust structure into consideration and effectively saves taxation cost which the researcher believes is helpful for securitization transactions development.

However, one major annoyance is that tax agency didn’t announce any general rules for every case but screening on a case by case basis which increased uncertainty and time needed to process examination and this delay and added risk could devastate a transaction sometimes.

3.2 Accounting Principles

Accompanied with the emergence of securitization, related accounting standards are necessary for both sides of a transaction to record this event and adjust correlated accounts and entries. Just like the creation of the main structure and legal framework of securitization, accounting standard No. 33 was referenced to existing accounting standards in advanced countries: FASB 140 and IAS 39. Accounting standard No. 33 clarified recognition and derecognition of transferred assets, accounts adjustment for sellers and investors, disclosure requirements, guidelines for handling non-performance loans, and combined financial reports of originators and special purpose entities.

This standard is really helpful for companies to disclose effects of securitization deals and make their financial statements more accurate. Accounting standard No. 33 combined FASB 140, IAS 39, and accounting standards in Taiwan trying to create one coordinated principle for securitization deals and also connect to the spirit of international accounting standards. This is not an easy job and we’ll talk about this in section four.

3.2.1 Derecognization

Basic Requirements

Standard 33 provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under particular conditions while some requirements are satisfied, assets and sold or transferred to a special purpose entity together with relative liabilities in a securitization transaction should be eliminated from balance sheet of originators (see exhibit 3-1). Special purpose entity recognizes the financial and servicing assets it controls and the liabilities it has incurred. This Statement provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

The key factor is whether the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

> First, the transferred assets have been isolated from the transferor-put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
>
> Second, each transferee (or, if the transferee is a qualifying special-purpose entity (SPE), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
>
> Third, the transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.[1]

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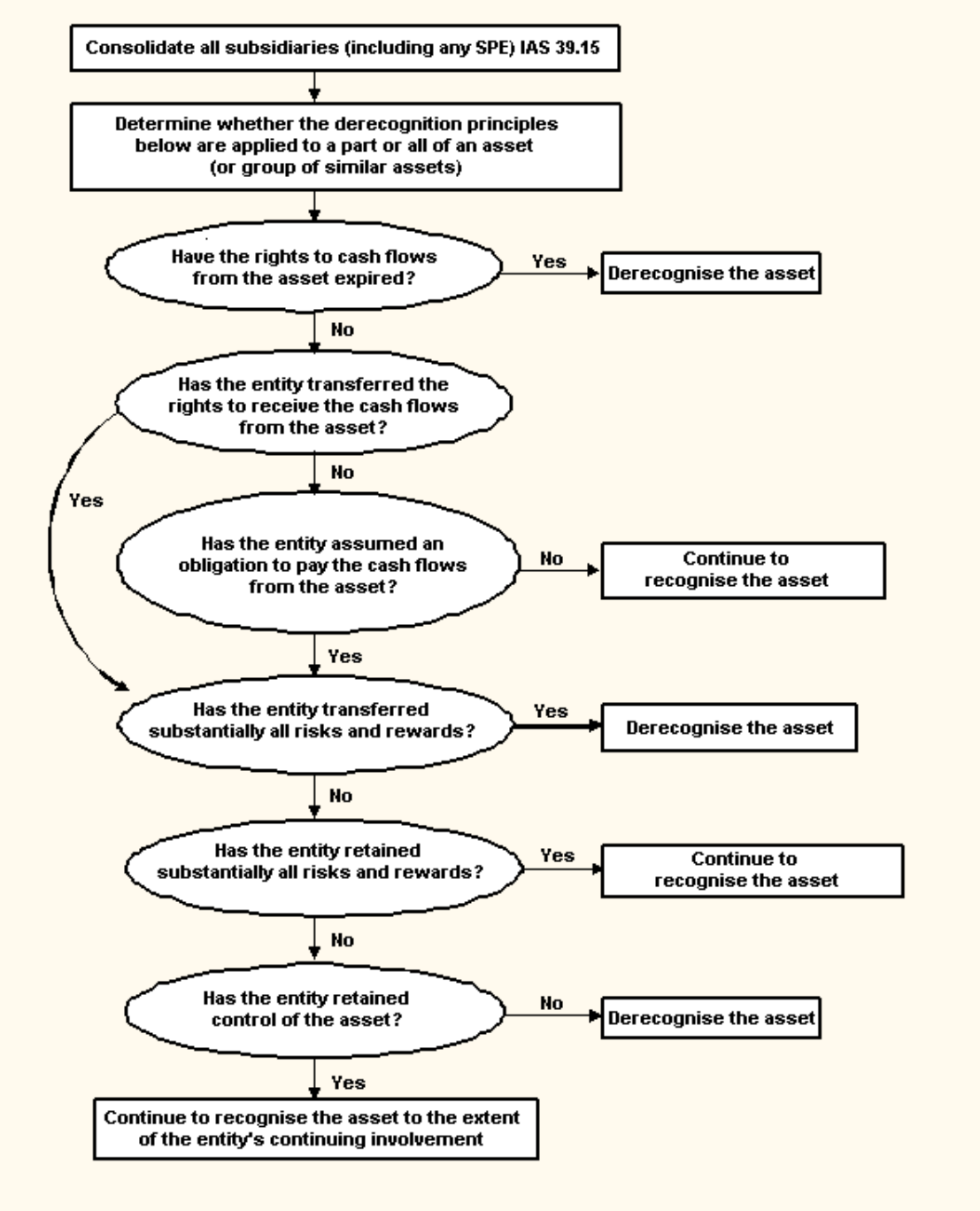
[1] *Lease Training Services: FASB 140*, ExecutiveCaliber Web Site.

Exhibit 3-1 Various Derecognition Steps



Source: Financial Instruments: Recognition and Measurement.

Details

The specific effectiveness of transferor's surrender needs to be examined in a more precise scope which considers bilateral relationship of transferor and holder. Surrender will be void and both assets transferred and liabilities incurred could not be

recognized by both originators and trustees if the transferor still holds control over underlying assets in various forms.

Transferors

Examples of transferors are still holding control over underlying assets and therefore they cannot derecognize related entries are: (1) Transferors have the right to make holders to return transferred assets. On exception is that the underlying asset is available in the market or the repurchase price paid by transferors is fair market value at the time of return; (2) Transferors have the rights and obligations to redeem or repurchase the underlying assets and the terms of repurchase/redemption give holders 'lender's profits' which equals the profit holders can earn in a secured finance transaction; (3) Underlying assets are not available on market and all risks and premiums of assets belong to transferors still, for example, holders can exercise put options.

Holders

It is a required condition for transferors to derecognition assets and liabilities that holders are able to have complete yields derived from underlying assets without interruptions. Holders having intact rights to sell or lease out collaterals at fair market value independently and special purpose entity and its beneficiaries having perfect access to derived yields are two circumstances that transferors can state effectiveness of surrender.

Both Sides

In fact, it is more appropriate to put both holders and transferors together when looking at the accounting requirement conditions for participants to derecognize relative entries listed in former sections. This topic sometimes can be, or more precisely is more proper to be, handled on a case by case basis since its complications and variations. The bottom line is, only when transferors surrender control over underlying assets and holders or special purpose entities possess complete and intact rights to harvest all proceeds, then one can claim the derecognition. We consider two cases below to further strengthen this principle.

For a bank who sold its receivables to another bank and also trying to prevent the buyer transferring or selling these receivables to a hostile third party, for example the seller's competitors, so as to end up in a situation of losing customers, some

forbidden provisions may be arranged. As long as the transferor do not have repurchase or redemption rights over transferred assets, restrictions on assets holders do not keep both sides from taking consecutive accounting treatments. In the contrary, all assets should keep on the seller's balance sheet if holders have a put option which can be exercised in the future to return the assets transferred which is also not available in the market.

3.2.2 Accounts Adjustment

When transferors sold whole assets without split, book value is recognized on the balance sheet. The total amount buyers paid minus total cost and any adjustment of book value of assets to fair market value should be counted as current income on income statement. In transactions where only part of the whole asset is sold, the relative weights of fair market value of corresponding parts should be used to recognize book value on the balance sheet. If the fair market value is not available at the time of trading, total amount of book value will go to the part sold out which means sellers is assumed selling out total asset.

It is not an unusual scene that buyers or sellers encounter new assets or liabilities during the transaction and as anyone may expected, we use fair market value to recognize any changes and make adjustments to related entries. According to conservatism, any new assets the participants acquired without fair market value or can't derive one by using reliable judgment should be recorded as zero. Any new liabilities the participants encountered without fair market value or can't derive one by using reliable judgment should ignore any gains but recognize any loses.

3.2.3 Combined Financial Statements

FASB 140 required transferors and non-qualifying special purpose entity to make combined financial statements. Under certain requirements that one special purpose entity would be considered as a qualifying special purpose entity (QSPE) which need not be included into one combined financial reports with the originator. Whether a SPE can be treated as an independent entity and all assets and liabilities transferred can be derecognized from originators are critical terms for a securitization transaction[2] and usually have huge impact on income statement items of the originators. Exhibit 15 is the related rules under FASB 140.

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[2] The mistreatment of recognition of securitization transactions of Freddie Mac made Freddie Mac's EBT increased 181 million dollars after corrected it.

Exhibit 3-2 Requirements of Derecognition

CONDITION	QUALIFICATIONS
a. It is "demonstratively distinct" from the transferor	It can not be unilaterally dissolved by the transferor, its affiliates or its agents AND either (1) at least 10% of the fair value of its beneficial interests is held by independent third parties or (2) the transfer is a guaranteed mortgage securitization. The 10% requirement (for non-guaranteed mortgage securitizations) must be met at all times including the ramp up or wind down phase of a deal. When not met, the SPE is consolidated.
b. Limits on permitted activities	Its permitted activities : (1) are significantly limited (2) are entirely specified upfront in the legal documents that created the SPE or its beneficial interests (3) may be changed only with the approval of the holders of at least a majority of the beneficial interests held by independent third parties. It is not always clear which decisions are inherent in servicing the asset and which go beyond the customary responsibilities of servicing, which also vary by the type of asset.
c. Limits on the assets it can hold	It may hold only: (1) Passive financial assets transferred to it (2) Passive derivative financial instruments that pertain to beneficial interests owned by independent third parties (3) Financial assets such as guarantee policies or other rights of reimburse- ment for inadequate servicing by others or defaults or delinquencies on its assets provided such agreements were entered into when the entity was established, when assets were transferred to it, or when securities were issued by it (4) Related servicing rights (5) Temporarily, non-financial assets obtained in the process of foreclosure or repossession

	(6) Cash and temporary investments pending distribution to security holder
d. Limits on permitted sales, exchanges, puts, or distributions of its assets	It can only dispose of assets in automatic response to one of the following events: (1) Occurrence of an event that: a. is specified in the applicable legal documents; b. is outside the control of the transferor, its affiliates and its agents; and c. causes or is expected to cause the fair value of those assets to decline by a specified degree below their fair value when the SPE obtained them (2) Exercise of a put option by a third-party beneficial interest holder in exchange for: a. a full or partial distribution of assets b. cash (which may require that the SPE dispose of assets or issue beneficial interests to generate cash to fund the settlement of the put) c. new beneficial interests in those assets (3) Exercise of a call option or ROAP by the transferor (4) Termination of the SPE or maturity of the beneficial interests on a fixed or determinable date that is specified at inception