

**Special Purpose Entities (SPEs) and the  
Securitization Markets**

**Discussion Paper  
International Swaps and Derivatives Association  
The Bond Market Association**

**January 31, 2002**

# Special Purpose Entities (SPEs)<sup>1</sup> and the Securitization Markets

## Overview

Special Purpose Entities (“SPEs”) are legal entities created for a particular purpose and are used in structuring a wide range of capital markets products across the globe. This paper describes SPEs created in connection with securitizations. The U.S. securitization market has grown to \$5.2 trillion, providing necessary liquidity to U.S. financial institutions and their customers, including both individuals and businesses.<sup>2</sup> SPEs are a critical component of this process.

Securitization market growth is due primarily to market acceptance of the strength of securitization transactions in providing investors with sound investment opportunities and U.S. financial institutions and their customers with necessary liquidity. The liquidity provided by the securitization markets results not only in making credit more widely available to consumers in the form of mortgage, auto, student and home equity loans, as well as credit cards and other credit products, but it also results in lower interest rates for customers.

## What is Securitization?

- Securitization is a process by which securities are created whose payments are supported by cash flows generated by of a pool of financial assets. This process provides funding to the marketplace, thereby helping to ensure that consumers can obtain necessary credit. The efficiencies realized by the marketplace through securitization are passed on to consumers in the form of lower interest rates. Absent securitization, the cost of obtaining consumer credit would likely increase, because it would be more costly for lenders to obtain the funds necessary to extend credit or make loans to consumers.
- Residential and commercial mortgages, home equity loans, student loans, credit card receivables and other such promises to repay debts are among the assets of the lender that can be securitized. These assets--which include the payments that borrowers are obligated to make to lenders in the form of principal and interest (“P&I”) payments--are deposited into an SPE. These payments in turn are used to make payments of P&I to investors on a specific group of securities, such as mortgage and asset-backed securities (“MBS” and “ABS”). Appendices A and B set forth the current and historical outstanding volume of MBS and ABS.

---

<sup>1</sup> Special Purpose Entities are also referred to as Special Purpose Vehicles (SPVs). The terms are used interchangeably in the financial markets.

<sup>2</sup> Source: The Bond Market Association, data as of September 30, 2001

- The securitization process benefits a range of parties, including consumers. For example, once a lender extends a mortgage loan to a borrower, those funds are out of the lender's hands and in the hands of the borrower. By selling the loans to an SPE that issues securities--and indirectly to investors in the capital markets--through the securitization process, those funds are replenished and are available for additional loan originations.
- For a basic graphic depiction of this process, see Appendix D.

### **What are SPEs and what function do they serve?**

- Securitization SPEs are legal entities such as corporations, trusts, or partnerships established for a specific and limited purpose. An SPE essentially acts as a depository for a specific group of assets in a securitization, and in turn, issues securities to the marketplace for purchase by investors.
- SPEs do not have the right or ability to engage in any activities other than those rights granted to them in the legal documents creating and governing the securitization transaction and the SPE. Once the SPE is created, it must operate as a wholly independent entity. This generally includes appointing its own directors, paying all of its own expenses, not paying the expenses of the selling entity and not commingling its assets with those of any other entity, including the seller.
- Once assets are transferred to an SPE, they are “legally isolated” and consequently are no longer available to the seller or its creditors. The deposited assets can be used only to make payments on the securities issued to investors and may not be reclaimed by the seller.
- Securitizations would not take place without the ability to establish SPEs. Investors do not want to take on any risk associated with the seller. They only are willing to take on a specified degree of risk associated with the specific pool of securitized assets in which they are investing. In other words, SPEs protect investors from the bankruptcy or other adverse credit event affecting the financial institution that establishes and/or sells assets to the SPE. These securitization SPEs are considered “bankruptcy remote” since they are isolated from the financial institution that created and/or sold assets to them, and are precluded from taking on new activities and new financial obligations.

### **Why invest in securitized instruments?**

- Diversification: Securities issued by SPEs are typically backed by numerous assets. By investing in a pool of assets rather than in an individual asset, investors can diversify their risk. This is similar to the difference between investing in mutual

funds as opposed to individual stocks.

- **Liquidity:** There is an active secondary market in many types of ABS and MBS, whereas there is relatively little trading in the underlying assets themselves.
- **Varying investor needs:** Securitized instruments can be designed, or “structured” to meet different investor needs. For example, some investors require shorter-term investments, while others wish to make longer-term investments. Some wish to invest in securities that pay a fixed rate of interest, while others wish to invest in securities where the interest rate adjusts periodically.
- **Stability:** The securitization market has exhibited very stable credit performance overall, and has experienced relatively few adverse credit events such as downgrading or default of SPE securities or bankruptcy of SPEs.

### **Who invests in securitized instruments?**

Principally, large and sophisticated institutional investors, such as:

- Private pension funds
- Government pension funds
- Government agencies
- Banks and thrifts
- Bank trust departments
- Credit unions
- Insurance companies
- Money market funds
- Mutual funds

### **Who sets standards for accounting for SPEs?**

- The SEC has the legal authority to establish financial accounting and reporting standards for issuers of securities sold to the public, including SPEs and their sponsors. The SEC has delegated standard-setting authority to the Financial Accounting Standards Board (“FASB”), so long as the public interest is served.
- The FASB was established in 1973 and sets financial accounting and reporting standards for publicly and privately held companies.
- The FASB’s Emerging Issues Task Force (“EITF”) assists the FASB in the early identification of issues affecting financial reporting and with implementation of authoritative pronouncements.
- The SEC, the FASB and the EITF have issued a number of pronouncements on accounting for SPEs.

## **SPE Accountability**

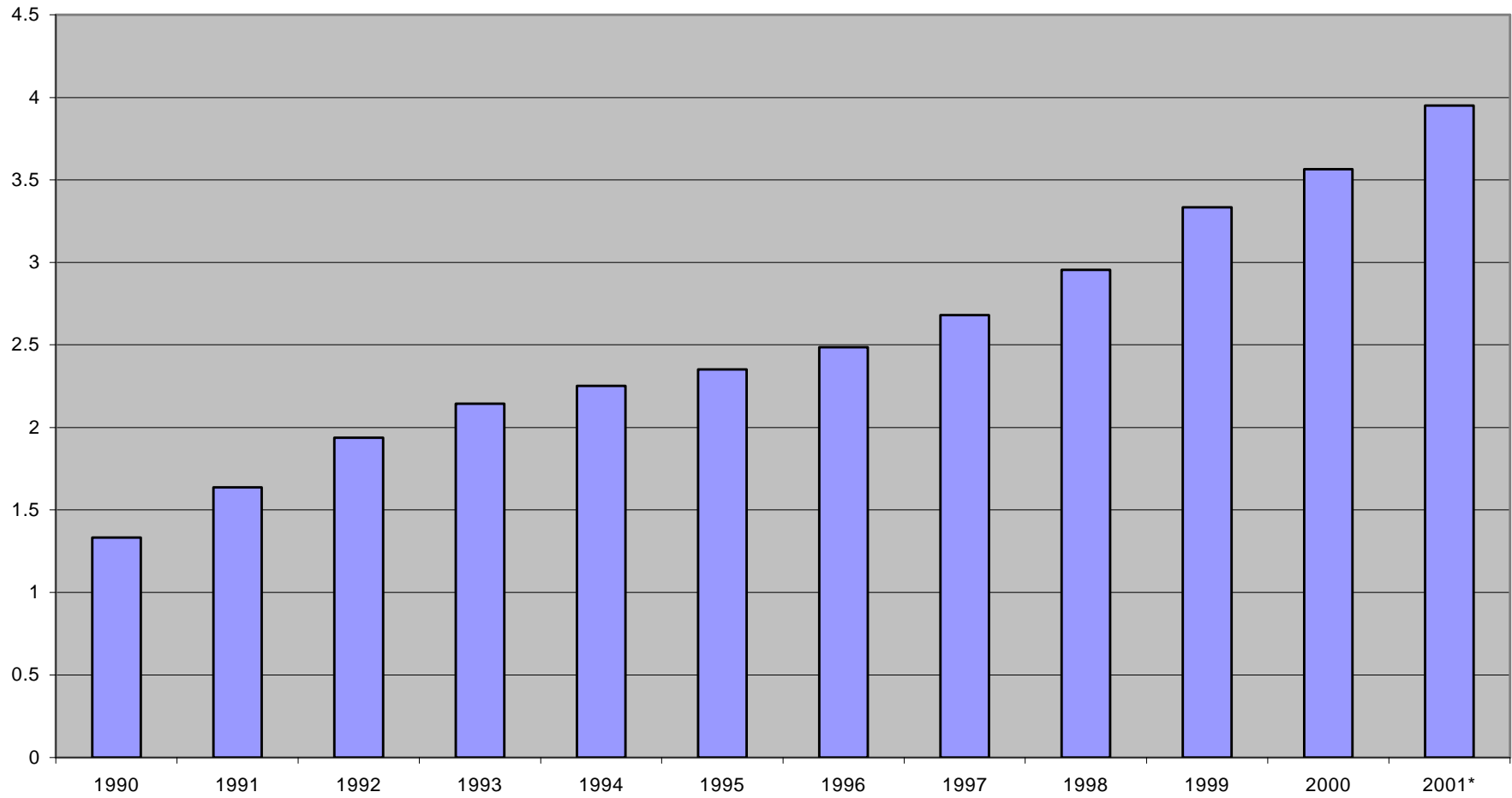
- Depending on the features of the SPE, the assets and liabilities of an SPE may or may not be required to be included, or “consolidated” in the financial statements of the entity that created the SPE.
- SPEs often are not permitted to be consolidated in the financial statements of the entity that created that SPE because doing so may make a company appear to be larger than it actually is. This would be particularly relevant in the event of a bankruptcy, where any assets deposited into a bankruptcy-remote SPE could not be accessed by the creditors of the entity that created it, even if the SPE has been consolidated in (or appears on) that entity's financial statements. In addition, consolidating an SPE on the financial statements of a company would imply a level of control over the SPE which the company does not exercise.
- Even without consolidating the SPE, any risks associated with SPE transactions are required to be disclosed in a company’s financial statements.
- Lending obligations to SPEs are included in disclosures about commitments.
- Securities issued by the SPE, but retained by the financial institution that established the SPE rather than sold to third parties, are included on the balance sheet and disclosed in the footnotes to the financial statements.
- Derivative positions<sup>3</sup> with SPEs are recorded on the balance sheet and disclosed in public filings.

---

<sup>3</sup> For example, the selling financial institution may be a counterparty to an interest rate swap agreement with the SPE to convert fixed rate assets into floating rate assets, or vice versa.

## Appendix A

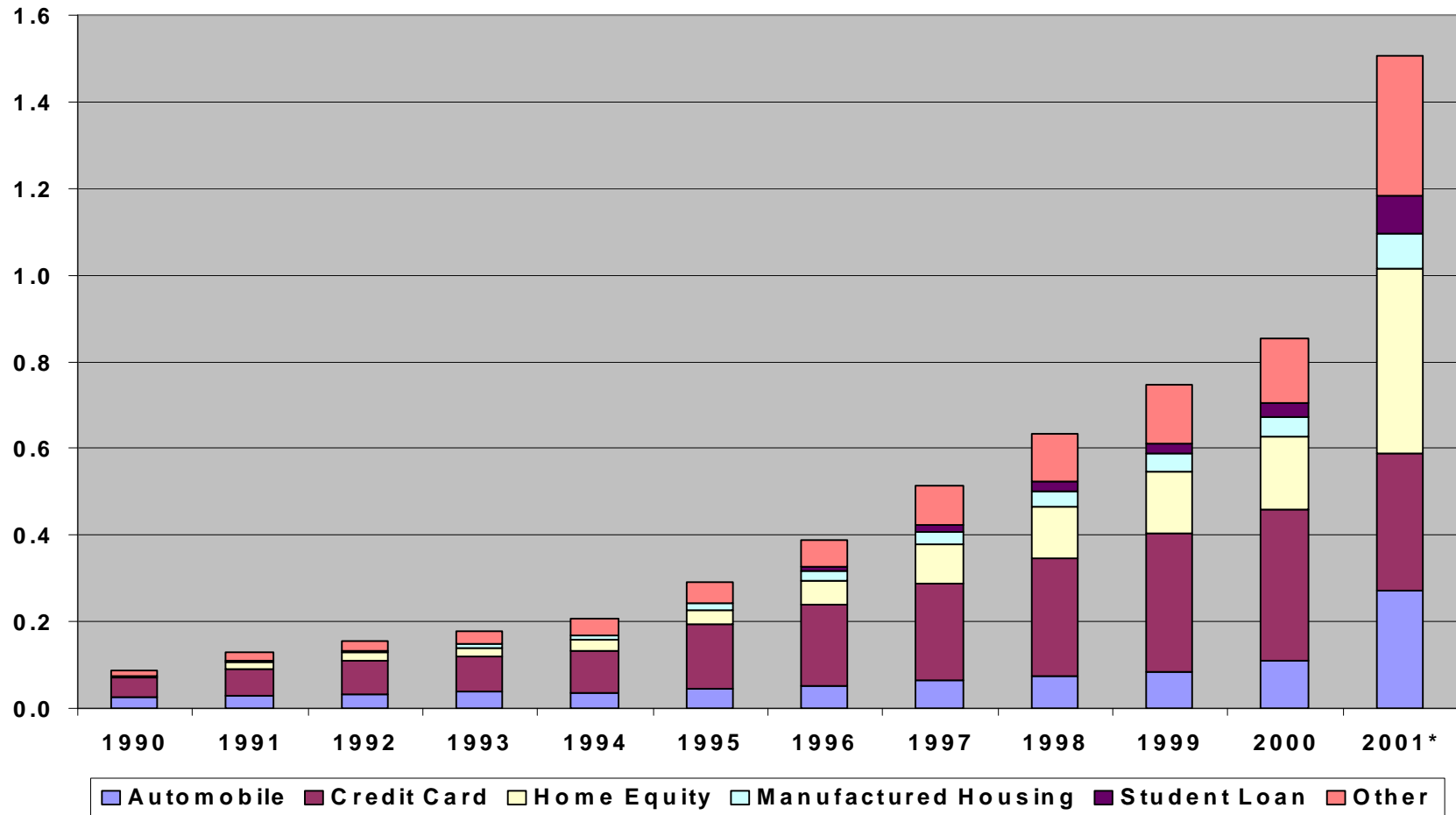
### Outstanding Volume of Mortgage-Related Securities (trillions)



Source: The Bond Market Association  
\*As of September 30, 2001

## Appendix B

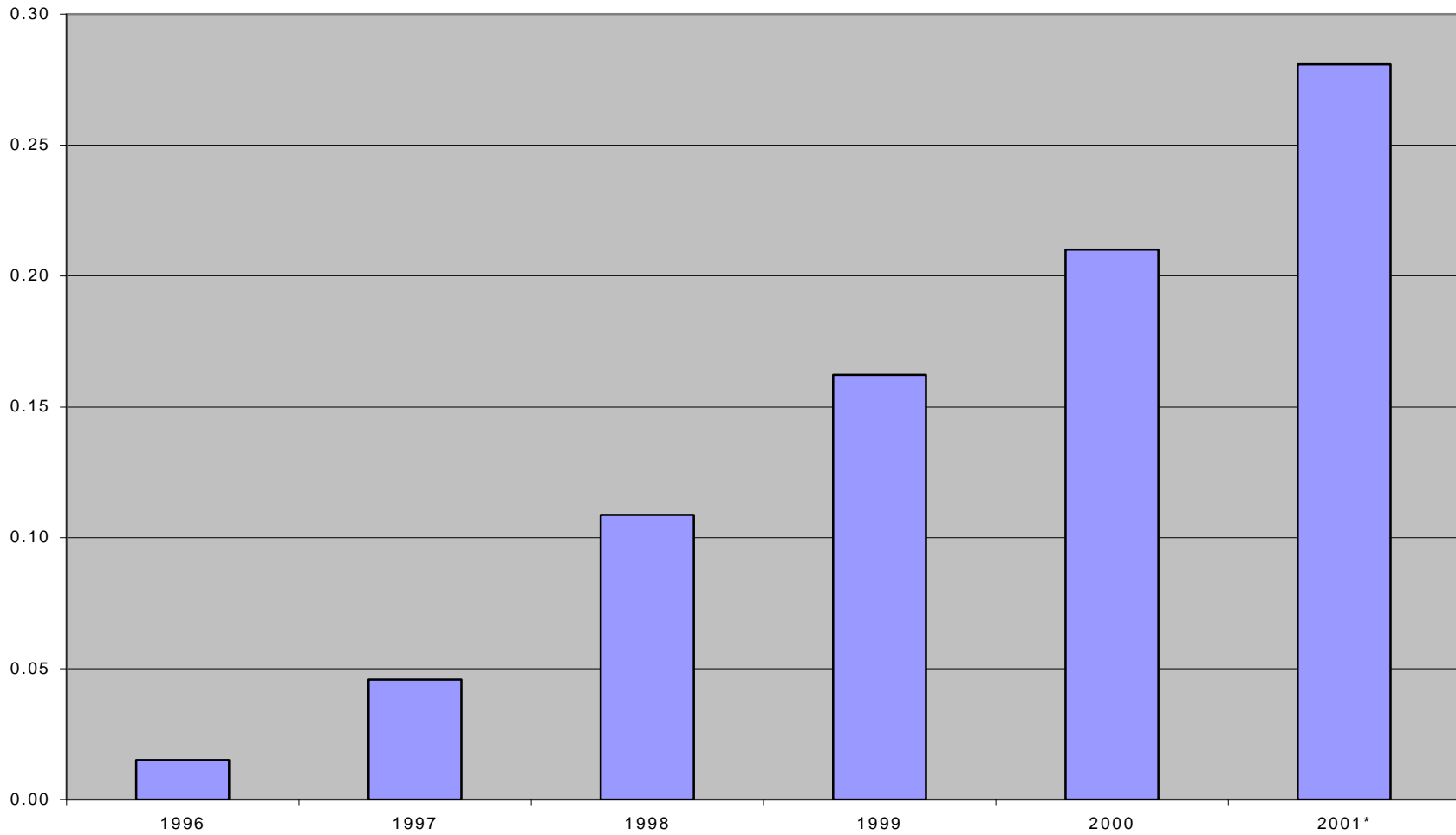
### Outstanding Volume of Asset-Backed Securities (trillions)



Source: The Bond Market Association  
\*As of September 30, 2001

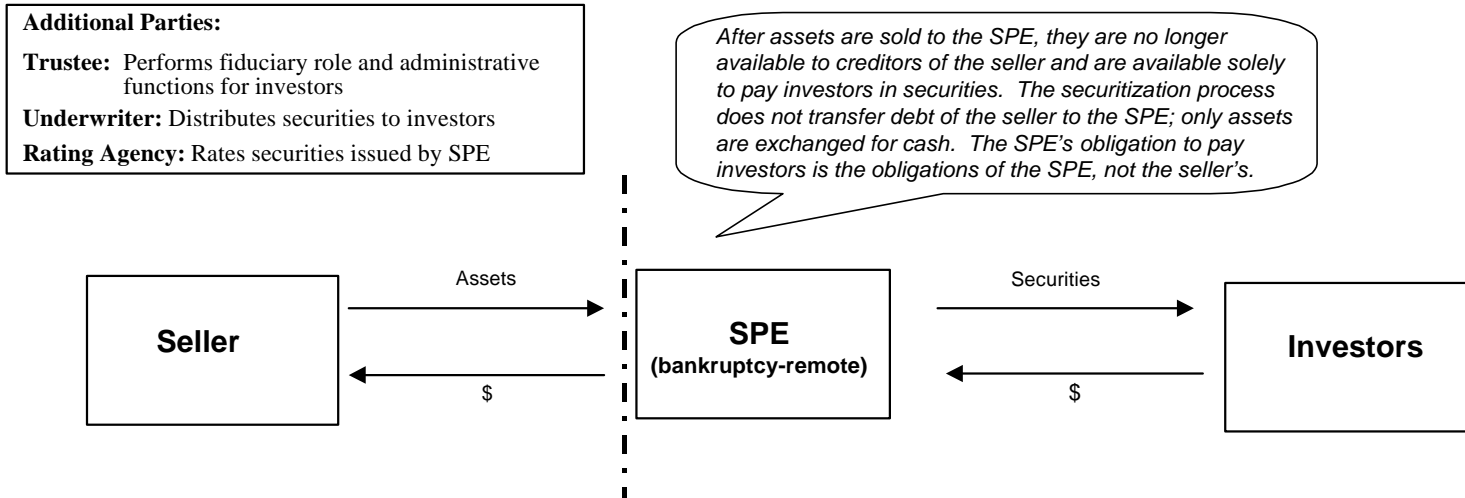
## Appendix C

### Outstanding Volume of Commercial Mortgage-Backed Securities (trillions)



Source: Trepp, LLC  
\*As of December 31, 2001

# Basic Securitization Structure



**Example:** Following is a general description of the securitization process, using mortgages and mortgage-backed securities as an example. Although there may be additional steps involved in a securitization, we describe here the basic process:

1. Seller (typically a mortgage lender) extends mortgage loans to borrowers.
2. Seller and a trustee representing investors create an entity (an "SPE").
3. Seller then sells a group, or "pool" of assets (mortgage loans) to the SPE into which the loans are deposited. The payment it receives in exchange for the loans replenishes the funds used to make the original loans. Those funds now are available to the lender for other uses, including making loans to other potential homeowners.
4. Based on the income stream expected from the mortgages held in the SPE, the SPE issues securities. The monthly principal and interest to be received from the mortgage borrowers will be used to make monthly principal and interest payments to investors in the issued securities. The securities that the SPE issues are called "mortgage-backed securities" ("MBS") because they are backed by the pool of mortgage loans that the SPE holds.
5. The securities then are sold into the marketplace to investors.



## Glossary

**ABS - (Asset-Backed Securities)** – Securities issued by an SPE that owns a pool of assets such as credit card receivables, student loans, home equity loans or other assets.

**Bankruptcy-Remote - (SPE)** – An SPE satisfying certain legal criteria, whose assets have been isolated from and are outside of the reach of the creditors of the institution from whom it purchased the assets. Bankruptcy remoteness is a critical feature of SPEs that protects the investors that purchase the securities issued by the SPE.

**CMBS – (Commercial Mortgage-Backed Securities)** - Securities issued by an SPE that owns a pool of large commercial mortgage loans.

**Consolidation** – An accounting term used to refer to the process of including the assets and liabilities of one entity, such as an SPE, in the financial statements of another entity, such as the sponsor of an SPE.

**FASB** – Financial Accounting Standards Board. Sets accounting standards for public and private companies.

**Interest Rate Swap:** A contract between two parties, wherein the first counterparty agrees to make fixed-rate interest payments to the second counterparty in exchange for floating-rate interest payments to the first counterparty by the second counterparty. The fixed rate of interest is called the “swap coupon”. The interest payments are calculated on the basis of a hypothetical amount of principal called the “notional principal” or the “notional amount”. Only the interest payments are exchanged, the notional principal is not exchanged.

**MBS – (Mortgage-Backed Securities)** – Securities issued by an SPE that owns a pool of mortgage loans

**P&I** – Principal and Interest payments on a loan or security

**Securitization** - A process by which certain securities are created from the cash flows of a pool of loans or other assets

**SPE** – Special Purpose Entity. Also referred to as SPV, Special Purpose Vehicle. SPEs are legal entities such as corporations, trusts, or partnerships established for a specific and limited purpose.

**SPV** – Special Purpose Vehicle. Alternate name for SPE.