

## **Securitization in Korea**

Securitization has been favored by Korean financial institutions as a restructuring tool because, through securitization of non-performing loans (NPLs) held by them, they can effectively dispose of NPLs and simultaneously secure the necessary funds required for reducing their liabilities so as to comply with the BIS ratio. Thus, in 1999, the ratio of NPL securitization out of the total volume of securitization was approximately 42.2%. As the economy gradually recovered from the shock caused by the so-called IMF crisis in 1998, the importance of securitization in the Korean market as a means of disposing NPLs has decreased significantly. According to the Financial Supervisory Service (FSS) of Korea, last year saw a dramatic decrease in the volume of the asset-backed securities ("ABS") securitizing NPLs as it was reduced from 10.6 trillion Korean Won in 2001 to 2 trillion Korean Won in 2002, thus constituting only 5% of the total ABS issuance in 2002. Further, the volume of "Primary CBO", which are government-guaranteed ABS securitizing the junk bonds issued by small and medium sized Korean companies suffering from temporary financial difficulties and subscribed by a government agency, was also reduced from 7.5 trillion Korean Won in 2001 to 0.8 trillion Korean Won in 2002 due to improvement in the financial conditions of the Korean companies.

Such decrease in the issuance of NPL ABS and Primary CBO resulted in the reduction of the total volume of ABS issuance in 2002 by 21.8% compared to 2001. However, the aggregate volume of ABS issuance excluding NPL ABS and Primary CBOs in 2002 was 37 trillion Korean won, which shows a 22.5% increase compared to 2001. Therefore, despite the decrease in the total volume of ABS issuance in 2002, securitization as a means to obtain low-cost financing is becoming more popular than ever and especially, the aggregate volume of cross-border ABS issuance has increased in 2002 by 74.7% compared to 2001. Further, more complicated and sophisticated financing techniques are being involved resulting in more complex transaction structures. For instance, the use of trust as a securitization vehicle has considerably increased.

Most of the securitization in Korea are transacted pursuant to the Act Concerning Asset-Backed Securitization (the "ABS Act"); however, the ABS Act does not necessarily require all securitization transactions to be subject to its jurisdiction. Nevertheless, in order to enjoy certain special exemptions provided under the ABS Act removing, or at least reducing, some of the strict procedural requirements under the Korean Civil Code in connection with

transfers of debt obligations and mortgages as well as to enjoy certain tax reduction or exemption granted under the Tax Preference Control Law (“TPCL”) and Corporate Income Tax Act, securitization should comply with the legal requirements of such Act. This article considers a brief outline of securitization under the ABS Act and the future developments in securitization as anticipated in view of the new legislation that is currently under discussion.

## **SECURITIZATION VEHICLE UNDER THE ABS ACT**

Three different types of securitization vehicles are recognized under the ABS Act: an ABS SPC, an Offshore SPC and a Trust. While an ABS SPC is an on-shore special purpose company established in the form of a *yuhan hoesa* (a limited liability company under the *Commercial Code*), an Offshore SPC is a foreign entity exclusively engaged in the business of securitization. The ABS Act expressly prohibits an ABS SPC from establishing any branch or hire employees. Further, an ABS SPC cannot engage in any business other than the businesses as specifically listed in the ABS Act. Although there is no express provision under the ABS Act regarding Offshore SPCs, it is understood, as a matter of practice, that the same restriction applies to an Offshore SPC as well. However, as to the ability of an Offshore SPC to establish a branch in Korea, the Ministry of Finance and Economy of Korea (“MOFE”) has given an official interpretation that the restriction on the establishment of a branch under the ABS Act does not apply to an Offshore SPC. Nevertheless, it should be noted that this interpretation was given for a case where an Offshore SPC had intended to establish a branch to obtain business license from the tax authorities so as to perform its tax liabilities in Korea. Therefore, even if an Offshore SPC is allowed to establish a branch in Korea, such a Korean branch has to remain as a passive entity and is not allowed to engage in any business other than those specifically listed under the ABS Act. As for using a trust as a securitization vehicle, only a trust company licensed under the *Trust Business Act* of Korea (including banks engaged in trust business) is permitted to act as a trustee. A foreign trust company is not qualified as a securitization vehicle, unless it holds a trust business license under the *Trust Business Act* of Korea.

## **ELIGIBLE ORIGINATORS**

Only the qualified originators listed in the ABS ACT (the “Originator”) are eligible to act as originators in securitizations pursuant to the ABS Act. The purpose of such limitation on qualifications of the Originators is to minimize the detrimental effects, which could be caused by the special privileges granted under the ABS Act. Currently, the eligible Originators are (i)

certain government entities and financial institutions and (ii) corporations having international reputation (including foreign corporations or Korean subsidiaries of foreign corporations) and having obtained FSC's recognition as to the necessity to securitize the assets held by such corporation pursuant to the standards prescribed by FSC.

## **PROCEDURES OF SECURITIZATION UNDER THE ABS ACT.**

### **Registration of the Securitization Plan**

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A securitization plan ("Securitization Plan") must be registered with the Financial Supervisory Commission of Korea ("FSC") by the relevant securitization vehicle as a first step of the ABS issuance. The Securitization Plan has to include, *inter alia*, the scope of the assets to be securitized ("Securitization Assets"), the classes of the ABS, matters concerning the Originator and matters concerning the management, operation and disposal of the Securitization Assets. Under the ABS Act, only one Securitization Plan can be registered per securitization vehicle.

FSC can deny registration of or demand changes to the Securitization Plan if (i) the documents for registration contain untrue or misleading information; (ii) the contents of the Securitization Plan are in violation of the ABS Act or relevant presidential decrees and regulation thereto; or (iii) the establishment of an ABS SPC is in violation of the relevant laws. In such a case, FSC must provide a written notice to the relevant securitization vehicle setting forth detailed reasons for such denial of registration or a demand to change within 15 days from the date when the application for registration is filed. If FSC does not issue any notice of denial or demand to change within this 15-day period, the Securitization Plan is deemed to have been duly registered as of the date that it was first filed.

### **Acquisition of the Securitization Asset by the Securitization Vehicle**

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Under the ABS Act, a securitization vehicle is to acquire the Securitization Assets only from the Originators and the transfer of the Securitization Assets by an Originator to an ABS SPC or an Offshore SPC must be done by a true sale that satisfies the requirements of Article 13 of the ABS Act. Article 13 of the ABS Act, if interpreted literally, does not apply to a securitization transaction that employs a trust as a securitization vehicle. However, in practice, FSC requires the same requirement for a transfer of asset by an

Originator to a trust. Upon transfer of the Securitization Assets to the securitization vehicle, the Originator must immediately register such transfer with FSC.

### **Appointment of Servicer and Business Trustee**

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The ABS SPC or an Offshore SPC (collectively, a “SPC”) must appoint a qualified servicer as its servicer (“Servicer”) and entrust the servicing of the Securitization Assets. In addition, all of the business of the SPC other than those specifically listed in the ABS Act should be delegated to a third party (a “Business Trustee”). Such a requirement is in line with the restriction on SPC’s ability to hire employees. While only certain qualified entities may act as a Servicer, there is no restriction on the qualification of a Business Trustee. Nevertheless, in securitizations involving public offerings of ABS, FSC has actually required a financial institution to be appointed as a Business Trustee in order to protect the interests of the holders of the ABS.<sup>1</sup> The Servicer and the Business Trustee need not be separate entities.

Under the ABS Act, (i) an Originator, (ii) a licensed credit information company established pursuant to the *Act Concerning Use and Protection of Credit Information* or (iii) such other persons specializing in the asset management business meeting the requirements prescribed by the Presidential Decree of the ABS Act may act as a qualified servicer.

### **Scope of Securitization Assets**

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Securitization Assets are defined in the ABS Act as “debt claims, real estates and other property rights that are being securitized.” As such, there is no legal restriction on the type of assets that can be securitized. Nevertheless, in practice, FSC has been somewhat reluctant to allow stocks of a corporation (*chusik hoesa* in Korean) to be securitized. Hence, the attempts to securitize shares of a corporation so far have been futile except in one case transacted in the initial stage of securitization in Korea. e-

### **Special Provisions on the Assignment of Debt Claims**

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Under Article 450 of the *Civil Code* of Korea, for an assignment of a debt claim to be

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<sup>1</sup> The term, Business Trustee, is a literal translation of the corresponding Korean term used under the ABS Act, however, the legal status of a Business Trustee is only an administrative agent of the SPC and not a trustee for the holders of the asset-backed securities. Nevertheless, FSC requires the Business Trustee to actually assume the duties of the holders’ trustee and to protect the interest of the holders.

duly perfected, a written notice of assignment should be given by the assignor to the obligor or a consent of an obligor should be obtained and such notice or consent must bear a fixed-date stamp.<sup>2</sup> The ABS Act provides special provisions which simplify such assignment procedures so that, for securitizations under the ABS Act, it is deemed that an assignment of a debt claim has been properly perfected as against third parties if the assignment of such debt claim is duly registered with FSC. In order for an assignment of a debt claim to be effective as against the relevant obligor, a notice to or consent from such obligor is still required; however, not only the assignor but also the assignee may give such notice of assignment. As a result, where the Securitization Assets are debt claims, so long as an assignment of such debt claims is duly registered with FSC, the assigned debt claims will not belong to the bankruptcy estate of the Originator. Nor will the creditors of the Originator be able to attach the assigned debt claims even if no notice is given to or consent from the obligor is obtained because such assignment is still effective as against third parties. Therefore, for a securitization involving multitude obligors of underlying assets, it is quite common to register with FSC only and notice to or consent from the underlying obligors is waived.

### **Special Provisions on the Assignment of Mortgage**

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The Korean *Civil Code* requires that assignment of mortgage interest to be registered with the court where the relevant the real estate is situated. In a transaction where the Securitization Assets consist of mortgages involving multiple numbers of real estates scattered all over the country, the registration of the assignment has to be made in each and every court where each relevant real estate is located. This is, undoubtedly, not only time-consuming but also very costly. However, the ABS Act has simplified this process by permitting a securitization vehicle to acquire a mortgage interest by means of registration of such assignment with FSC without any further registration on the real estates register kept by the relevant courts.

### **Protection Against Servicer's Insolvency**

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In order to protect the interests of the ABS holders against insolvency of the Servicer, the ABS Act requires the Servicer to manage the entrusted Securitization Assets separately from

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<sup>2</sup> The term "Fixed date" used in this Article 450 refers to a date appearing on a document which cannot be arbitrarily altered by the related parties. In Korea, a Korean notary public is authorized to affix a fixed date stamp on a document. Another way of affixing such fixed date stamp on a document is to send such document by a content-certified post, in which case, the stamp bearing a date affixed by the post office on such document constitutes the fixed date stamp.

its own assets. Further, in case of bankruptcy of the Servicer, such Securitization Assets that have been separately managed by the Servicer do not constitute a part of the bankruptcy estate of the Servicer, and the securitization vehicle may request the Servicer or the receiver of the Servicer to deliver to the securitization vehicle such Securitization Assets. The same will apply as to the commencement of the composition procedures under the *Composition Act* or the reorganization procedures under the *Corporate Reorganization Act*. Any creditor of the Servicer cannot enforce its respective claims against such Securitization Assets, and such Securitization Assets will not be subject to a preservation order or suspension order pursuant to the *Bankruptcy Act*, the *Composition Act* or the *Corporate Reorganization Act*.

## **TAX EXEMPTIONS AND REDUCTIONS**

### **Corporate Income Tax by an SPC**

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Generally, dividends are not deductible expenses under Korean tax law; however, the *Corporate Income Tax Act* provides a special tax benefit for an ABS SPC. Under Article 51-2 of the *Corporate Tax Act*, if an ABS SPC distributes as dividend at least 90% of its distributable profits as prescribed in the presidential decree, the amount of such dividend shall be deducted from its taxable income. However, the above-mentioned tax benefit for corporate tax is not available to an Offshore SPC.

### **Tax Exemption or Reduction under TPCL**

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For the real estate acquired prior to December 31, 2003 by an ABS SPC for the purpose of securitization, acquisition and registration taxes are exempted pursuant to the TPCL.

## **FUTURE DEVELOPMENTS IN ABS TRANSACTIONS**

### **Securitization of Housing Loans**

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Currently, most of the housing loans in Korea are short-term loans with maturity falling within three years. The Korean government contemplates to change this trend by inducing the financial institutions to offer longer-term housing loans, having a term of at least 20 years. To this end, Korean government plans to raise long-term, low-interest funds by

issuing of mortgage-backed securities (MBS), which will be provided to Korean financial institutions for the purpose of extending long-term housing loans. Because the MBS issuer's creditworthiness determines the low financing cost in issuing MBS, the Korea Housing Financing Corporation ("KHFC"), will be established as a public corporation by consolidating the existing KoMoCo and the Korea Housing Financing Credit Guarantee Fund and KHFC will act as the issuer of long-term MBS. The Korean government is currently under the process of preparing a bill for the KHFC Act with a goal to establish KHFC by January 2004. Following are the legal reforms expected to be included in the bill so as to facilitate issuance of MBS by KHFC:

- (1) simplify the notice requirement by allowing the notice fixing the amount of the indebtedness secured by kun-mortgage and the notice of assignment to be given simultaneously (currently, these notices should be given separately);
- (2) simplify the securitization process by allowing the creditors to obtain an advance consent from the debtor for assignment of the relevant indebtedness with a view to ultimately securitizing such indebtedness at the time when such indebtedness is first created; and
- (3) legislate a special provision to allow KHFC to file an amendment with FSC to change the details of mortgage registered with FSC in case changes thereof become necessary after registration has been filed with FSC. (Currently, if mortgage transfer registration is filed with FSC, court registration requirement under the *Civil Code* is waived. However, as there is no provision for filing an amendment to the registration already filed with FSC, if any change to the details of the mortgage (e.g., a change of debtor) occurs after FSC registration, a mortgage registration with the court, which had originally been waived, had to be made to reflect such change).

## **Securitization of Student Loans**

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Student loans granted by financial institutions in Korea are usually short-term loans (four years or less in term). In addition, as most students are not able to provide collateral, student loans are not readily available and even when granted, these loans have a high interest rate. Currently, the Korean government is reviewing a possibility of securitizing the student loans through the Korea Housing Financing Corporation so as to provide long-term, low-interest student loans.