

## Securitization in Korea

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### **Abstract**

*Before 1997, other than few offshore securitization transactions, domestic asset-securitization cases were almost non-existent in Korea.. Although there were strong demands in the financial market for such transaction, it was very difficult to structure the transaction economically viable and free from uncertainties and legal risks due to various restrictions under the Korean Commercial Code and other trust related laws and regulations of Korea. The Act Concerning Asset-Backed Securitization Act (the “ABS Act”) was enacted in September 1998 to facilitate and promote securitization. This ABS Act substantially removed the then existing legal barriers to securitization of assets. The ABS Act further conferred certain procedural privileges and benefits for securitization that met the requirements set forth under the said Act. While compliance with these requirements is a prerequisite to enjoy the benefits under the ABS Act, the ABS Act does not mandate that all securitization transactions to be subject to it. However, certain tax exemptions are granted only to those asset-securitization complying with ABS Act. Although, it is not impossible to structure an asset-securitization that does not comply with the specific requirements or conditions of the ABS Act, such securitization transactions will not be entitled to the benefits under the ABS Act or the tax reductions and exemptions under relevant tax laws of Korea. Since the enactment of the ABS Act in 1997, securitization has become one of the most popular financing techniques in Korea and the volume of transactions that have successfully closed since has grown exponentially over the years. With increasing demand for securitization in Korea, it is expected that the ABS Act will be further fine-tuned as the Korean financial market gains experience and skills in relation to securitization through trial and error.*

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## **I. Legislative History and Nature of the Act Concerning Asset-Backed Securitization of Korea**

Until 1997, there was almost no financial transaction in Korea which can be categorized as securitization transactions, other than a very few offshore securitization transactions involving Korean financial institutions' foreign currency denominated assets (including exchange notes and letters of credit) through an offshore special purpose vehicle<sup>1)</sup>. This was mainly due to the various restrictions under the Korean Commercial Code (henceforth, the "Commercial Code") and other trust related laws and regulations of Korea.

It is not totally wrong to say that securitization transactions were possible even before the enactment of the Act Concerning Asset-Backed Securitization (the "ABS Act"). Under the then current laws of Korea, securitizations could have been carried out by transferring the underlying assets to a special purpose company and then having such company issue bonds or equity shares. However, such structure was not economically viable due to the restrictions under the Commercial Code. Under Article 470 of the Commercial Code, the aggregate outstanding principal amount of the bonds and debentures issued by a company could not exceed four (4) times the amount of net assets of such company as shown in its previous year's balance sheet. Therefore, using a special purpose company established under the Commercial Code to issue equity securities or bonds was not an economically viable structure.<sup>2)</sup> Although using an offshore special purpose company as a securitization vehicle was an alternative solution, such offshore vehicle was viewed as a non-resident under the Foreign

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1) Strictly speaking, these offshore transactions cannot be referred to as securitization transactions in the Korean financial market because these transactions have no connection with Korea except that the originators of the underlying assets are Korean financial institutions.

2) When using such method, a special purpose company is established with a certain amount of paid-in capital. The company will then issue bonds in the amount of four (4) times of the amount of such paid-in capital (as such company will have no other assets or debts, the net assets of such company will be equal to the amount of the paid-in capital) and subsequently acquire mortgage-backed loans or such other assets to be securitized ("Acquired Assets"). Upon acquisition of the Acquired Assets, the company will then issue additional bonds in the aggregate amount equal to four times the value of the Acquired Assets. This procedure will have to be repeated until the aggregate principal amount of bonds reaches the desired amount. However, such method would substantially reduce economic benefit as well as transactional efficiency due to high transaction and financing costs.

Exchange Control Act of Korea and raised foreign exchange control authorization issues. In most cases, authorization from the Korean foreign exchange authorities were very difficult to obtain.<sup>3)</sup> Further, using a trust as a securitization vehicle instead was not viable at that time because Article 17-2 of the Trust Business Act of Korea, which is the only provision in the Trust Business Act related to issuance of beneficial certificates (*suikjeungkwon* in Korean) by trust companies refers to issuance of beneficial certificates where the entrusted assets are cash only. Therefore, it was not clear whether beneficial certificates could actually be issued where assets other than money are entrusted.<sup>4)</sup> Due to these inadequate or ambiguous provisions under such trust laws, structuring a transaction using a trust involved uncertainties and legal risks. Therefore, realistically speaking, it was a difficult environment for the promotion of securitization transactions in Korea.

Following the economic crisis at the end of 1997, restructuring or disposal of non-performing assets of Korean financial institutions and companies became one of the most urgent economic agenda. Asset securitization method was actively discussed as a very effective means of restructuring because it effectively disposed of non-performing loans and at the same time provided the necessary funds required for reducing the liabilities of the financial institutions and companies.<sup>5)</sup> As a result, the ABS Act was enacted in September 1998 to facilitate and promote securitization (which has already been a widely adopted in many developed countries) in Korea.<sup>6)</sup> The ABS Act clearly

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3) This is why all of the few securitization transactions done before the enactment of the ABS Act used an offshore special purpose company as a securitization vehicle. In these transactions, Korean foreign exchange authorization issue was easily resolved because the underlying assets used were foreign currency denominated bill of exchange or letters of credit held by Korean financial institutions and the then effective Foreign Exchange Control Act exempted Korean financial institutions from authorization requirements for transfer of such assets to non-Korean residents. However, for other originators who were not financial institutions, certain foreign exchange authorizations such as an approval from the Ministry of Finance and Economy, which was practically impossible to obtain at that time, were required and this effectively barred other originators' attempts to pursue a securitization using an offshore vehicle.

4) When Article 17-2 is read together with other provisions of the related laws and regulations such as Securities Investment Trust Act, it was quite likely that the answer is negative. Moreover, there were no court precedents or official interpretation by government authorities on this issue.

5) Seung-Han Yoon, *The Theory and Practice of the Securitization in (Korean)* 64-65 (1998).

6) Although a separate special legislation in relation to a SPV solely for the purpose of securitization of mortgage-backed housing loans has been launched in January 29, 1999 due to its long-term duration and strategic importance in relation to government policies, this paper will focus on the ABS Act as the prevailing law on securitization.

removed the above-mentioned barriers to securitizations by expressly providing that the restrictions on the aggregate outstanding principal amount of the bonds specified in the Commercial Code does not apply to the bonds issued by special purpose companies established for the sole purpose of securitization and further allowing trust companies to issue beneficial certificates as ABS securities regardless of the type of the entrusted assets. Since the enactment of the ABS Act, securitization has become one of the most popular financing techniques in Korea.

Although the main reason for the birth of the ABS Act was to achieve an effective disposal of non-performing loans held by Korean financial institutions and companies, the securitization under ABS is not restricted to securitizing such non-performing loans. The scope of the ABS Act is so wide that it can accommodate any type of asset securitization, such as mortgage-backed securitization by means of issuance of the mortgage-backed securities or securitization of any underlying assets with future cash flows. Therefore, the ABS Act and related regulations have paved a way for Korean financial institutions and companies to seek an alternate finance by way of securitizing their assets with future cash flows. Unlike the U.S. financial market, which has gradually progressed from rudimentary to sophisticated securitization transactions in accordance with the market principle, the Korean securitization market has only started with the enactment of the ABS Act.

The ABS Act sets forth the procedure for securitization as well as certain requirements to be complied with in order to be regarded as securitization transaction under the ABS Act. Further, ABS Act offers certain special exemptions from strict procedural requirements under the Korean Civil Code and other general civil laws so that certain legal huddles to securitization transactions would be avoided or at least reduced to an acceptable level. In addition, under the Tax Preference Control Law (“TPCL”), certain tax reduction or exemption is granted to securitization transactions performed under this ABS Act. However, ABS Act does not necessarily require all securitization transactions to be subject to it. The legislative purpose of the ABS Act is to promote securitization of assets in Korea by conferring certain privileges and benefits if such transaction complies with the requirements of the ABS Act. Therefore, theoretically, securitization without complying with the requirements of the ABS Act is possible. However, in such a case, the special provisions allowing certain procedural exemptions and tax exemptions under TPCL would not be available. In other words, the ABS Act does not prohibit securitization which do not comply with its specific requirements or conditions provided therein; it only means that such securitization

transactions will not be able to enjoy the benefit under the ABS Act or the tax reductions and exemptions under TPCL.

## II. General Concept of the Securitization under the ABS Act

In the US financial market, securitization is not a legally defined term and is often used to mean a variety of financial transactions which have developed over time.<sup>7)</sup> In contrast, Article 2 of the ABS Act defines what constitutes an “Asset-Backed Securitization” under ABS Act.<sup>8)</sup> Pursuant to such definition, securitization under the ABS Act can be divided into two main structures. One structure uses a separate special purpose company established for the sole purpose of securitization. The other uses a trust as the securitization vehicle. Under the special purpose company structure, the

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7) See Kirschenbaum & Holliday, *Securitization: A Look at the Basics*, Com. Investment Real Est. J., Winter 1990, at 15 (noting “Securitization is a widely used and not very widely understood term.”).

8) Article 2 (Definitions)

The terms used in this ABS Act shall be defined as follows: <Amended by Act No. 6073, Dec. 31, 1999; Act No. 6181, Jan 21, 2000; Act No. 6275, Oct. 23, 2000>

1. The term “Asset-Backed Securitization” means the activities falling under one of the following items:
  - (a) A series of activities involving issuance of asset-backed securities by a special purpose company (including foreign corporations specializing in the business of Asset-Backed Securitization) using securitization assets transferred to the special purpose company by the originator as the underlying assets, and payment by the special purpose company of amounts of principal and interest or dividends with respect to the asset-backed securities out of the earnings or loans, etc. accruing from the management, operation, or disposition of the securitization assets;
  - (b) A series of activities involving issuance of asset-backed securities by a trust company under the Trust Business Act (including banks concurrently engaging in the trust business; hereinafter referred to as a “trust company”) using securitization assets received in trust by the trust company from the originator as the underlying assets, and payment by the trust company of the proceeds of the asset-backed securities out of the earning or loans, etc. accruing from the management, operation, or disposition of the securitization assets;
  - (c) A series of activities involving acquisition by a trust company of securitization assets from the originator using funds received in trust by the trust company through issuance of asset-backed securities and payment by the trust company of the proceeds of the asset-backed securities out of the earnings or loans, etc. accruing from the management, operation, or disposition of the securitization assets; or
  - (d) A series of activities involving issuance of asset-backed securities by a special purpose company or a trust company using securitization assets, or asset-backed securities issued on the basis of such securitization assets, which are transferred or entrusted to the special purpose company by another

special purpose company will issue securities or other instruments (representing its equity or debt) after acquisition of the underlying assets to be securitized (“Securitization Assets”) and payment of interest, principal and dividend will be made from the cashflow arising from the management, operation and disposal of the Securitization Assets by the special purpose company.<sup>9)</sup> In the case of a trust structure, the trustee will issue beneficial certificates representing beneficial ownership interest in the cashflow from the management, operation and disposal of Securitization Assets by the trustee.<sup>10)</sup> The securities or other instruments issued by the special purpose company representing debt or equity in such company as well as the beneficial certificates issued by the relevant trustees constitute the asset-backed securities under the ABS Act (“Asset-Backed Securities”). Therefore, the concept of Asset-Backed Securitization under the ABS Act can be explained as the sale of equity, debt instruments or beneficial certificates, representing beneficial ownership interests in, or secured by, a segregated income-producing asset or pool of assets held by a special purpose company or a trustee on behalf of a trust in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and/or to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.

The definition of the Asset-Backed Securitization provided in the ABS Act may not be an exhaustive definition covering any and all transactions performed in the financial market under the name of securitization. The legal implication of the definition of the Asset-Backed Securitization in the ABS Act is that in order to enjoy the legal benefits and privilege under the ABS Act and TPCL, a transaction should be structured to fall within such definition.

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special purpose company or trust company as the underlying assets, and payment by the special purpose company or trust company of amounts of principal and interest, dividends, or earnings of the asset-backed securities issued by the special purpose company or trust company out of the earnings or loans, etc. accruing from the management, operation, or disposition of the securitization assets or asset-backed securities originally transferred or trusted;

9) Article 2(1)(a) of the ABS Act.

10) Article 2(1)(b) and (c) of the ABS Act.

### **III. Outline of Securitization under the ABS Act**

#### *A. Securitization Vehicle*

Under the ABS Act, a securitization vehicle which will hold Securitization Assets and issue Asset-Backed Securities should be in the form of either (i) a special purpose company established under Chapter 3 of the ABS Act (“ABS SPC”), (ii) a trust company (including a bank also engaged in trust business) under the Trust Business Act or (iii) an offshore company exclusively engaged in the business of securitization (an “Offshore SPC”. Also an ABS SPC and an Offshore SPC shall be collectively referred to as an “SPC”).

#### **1. ABS SPC**

The ABS Act requires that an ABS SPC must be established as a *yuhan hoesa* (a limited liability company under the Commercial Code). Further, under the Article 20 of the ABS Act, ABS SPC is not allowed to establish any branches or hire employees and prohibited to engage in any business other than the following business as listed in Article 22 of the ABS Act:

- (a) purchase or transfer the Securitization Assets or entrustment with a trust company;
- (b) management, operation and disposal of the Securitization Assets;
- (c) issuance and repayment of securities;
- (d) execution of agreements which are necessary to carry out the securitization plan;
- (e) temporary borrowing for repayment of securities;
- (f) investment of surplus fund; and
- (g) any other ancillary businesses related to sub-paragraphs (a) to (f) above.

It seems that the legislators intended the ABS SPC to remain as a passive company acting as a mere conduit rather than an active company so that the economic position of the ABS holders would be same or at least similar as if investment has been made in



the Securitization Assets directly. Furthermore, the ABS Act provides that the above businesses must be performed in accordance with the securitization plan registered with the FSC (the “Securitization Plan”). Hence, there might be a situation where an ABS SPC cannot engage in a business (even if such business falls on one of the above categories) if such business has not been considered in the Securitization Plan. Such a stringent restriction imposed on a ABS SPC would seem necessary in order to: (i) ensure that the investors of the securities will receive the same economic benefits as if they had made a direct investment in the Securitization Assets (by using such ABS SPC as a mere conduit) and (ii) protect the investors from unexpected risky investment.

## 2. Trust

Under the ABS Act, a trust company licensed under the Trust Business Act<sup>11)</sup> (including banks engaged in trust business) may act as a trustee to hold the Securitization Assets as trust assets and issue asset backed securities in the form of beneficial certificates. A foreign trust company, unless it also holds the trust business license under the Trust Business Act in Korea, may not be a trustee and issue ABS under the ABS Act.

## 3. Offshore SPC

The ABS Act provides that “a foreign corporation exclusively engaged in the business of securitization” may be used as a securitization vehicle.<sup>12)</sup> However, it is silent as to what is exactly meant by “exclusively engaged in the business of securitization”. In its literal reading of the ABS Act, Article 20 of the ABS Act limiting the legal capacity to conduct business applies to ABS SPC established as yuhan hoesa in Korea only. However, such an interpretation would not be in line with the legislative intent to restrict the legal capacity of the ABS SPC to the minimum extent necessary to exist as a conduit. As there is no reason to grant more legal capacity to an Offshore

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11) Under Article 3 of the Trust Business Act, a company may engage in trust business in Korea upon obtaining an approval of the Financial Supervisory Board of Korea.

12) Article 2(1)(a) of the ABS Act.

SPC than an ABS SPC established in Korea, Article 20 of the ABS Act should be analogously applied to a “foreign company”. Hence, the Ministry of Finance and Economy of Korea (“MOFE”) gave an official interpretation<sup>13)</sup> to the effect that an Offshore SPC should likewise be engaged solely in the business listed in Article 22 of the ABS Act. Therefore, currently, a foreign corporation can be registered as a SPC only if it is engaged solely in the businesses set forth in Article 22 of the ABS Act.

Nevertheless, MOFE has taken a rather contradicting position regarding whether an Offshore SPC may establish a branch in Korea. In its official interpretation given through the Finance Policy Division on May 14, 1999, it has taken the position that Paragraph 2 of Article 20 limiting ABS SPC’s ability to establish a branch applies to ABS SPC established in Korea only and does not apply to an Offshore SPC. Considering that this interpretation was given for a case where an Offshore SPC intended to establish a branch and file for business license with the tax authorities to perform its tax liabilities in Korea, it should be read in such context. Therefore, even if an Offshore SPC is allowed to establish a branch in Korea unlike Korean ABS SPC, such branch should not be involved in any active business other than those listed in Article 22 of the ABS Act.

## *B. Outline and Procedures of Securitization*

### 1. Registration of the Securitization Plan

The ABS Act requires that a Securitization Plan including, *inter alia*, the scope of the Securitization Assets, the classes of the Asset-Backed Securities, the management of Securitization Assets and the duration of securitization must be registered with the Financial Supervisory Commission of Korea (“FSC”) by the relevant securitization vehicle as a first step of the Asset-Backed Securitization under the ABS Act in order to enjoy the benefits and privileges provided under the ABS Act and TPCL.<sup>14)</sup> As the registration of the Securitization Plan should be made by the securitization vehicle, and not by the originator, an ABS SPC or an Offshore SPC should be established before

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13) The official interpretation given by the Finance Policy Division of the Ministry of Finance and Economy of Korea dated as of May 14, 1999.

14) Under Article 4 of the ABS Act, the following must be included in the Securitization Plan:

filing the Securitization Plan if an SPC is to be used as a securitization vehicle. The number of Securitization Plan, which can be registered, is restricted to only one (1) Securitization Plan per SPC.

Under Article 5 of the ABS Act, the FSC may refuse the registration of the Securitization Plan or demand that changes be made to the contents thereof if (i) the application documents for registration contains untrue or misleading information (ii) if the contents of the Securitization Plan is in violation of the ABS Act or relevant presidential decrees and regulation thereto or (iii) the establishment of the SPC is in violation of the relevant laws. In the event FSC elects to demand amendment of the Securitization Plan or refuse registration thereof, FSC must provide a written notice to the relevant securitization vehicle setting forth detailed reasons for such demand or refusal within 15 days from the date application for registration is filed.<sup>15)</sup> In the event FSC does not respond within this 15-day period, the Securitization Plan will be deemed as registered on the date that it is filed.<sup>16)</sup>

## 2. Acquisition of the Securitization Asset by the Securitization Vehicle

According to the definition of the Asset-Backed Securitization under the ABS Act, the securitization vehicle may acquire the Securitization Assets only from certain qualified parties which are listed as the “Originators” under Paragraph 2 of the Article 2 of the ABS Act. This means that only the assets held by these Originators may be

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- ( i ) Matters concerning the name of a special purpose company, etc. and the locations, etc. of offices thereof;
  - ( ii )Matters concerning the originator;
  - (iii)The duration of the Securitization plan;
  - (iv) Matters concerning the relevant securitization assets such as their types, total amount and valuation;
  - ( v ) Matters concerning the asset-backed securities such as their classes, total amount, and issuing terms and conditions;
  - (vi)Matters concerning the administration, operation, and disposition of the securitization assets;
  - (vii)Matters concerning the servicer provided in Paragraph 1 of the Article 10 of the ABS Act; and
  - (viii) Other matters prescribed by the presidential decree.

15) Paragraph 2 of Article 5 of the ABS Act and Article 7 of the Regulation on the Taking Actions regarding Asset-Backed Securitization Business published by the FSC.

16) Article 7 of the Regulation on the Taking Actions Regarding Asset-Backed Securitization Business.

securitized pursuant to the ABS Act. Upon transfer of the Securitization Asset to the securitization vehicle, the Originator must immediately register such transfer of the Securitization Assets to the FSC<sup>17</sup>.

In addition, Article 13 of the ABS Act provides that the transfer of the Securitization Asset by an Originator to an SPC must be done in the following manner and in accordance with the Securitization Plan filed with FSC;

- (i) The transfer should be effected by means of sale and purchase or exchange;
- (ii) The transferee should have the right to retain benefits from and the right to dispose of the Securitization Assets; provided, however, right of first refusal held by the transferor upon transferee's disposition of the Securitization Assets shall not be considered in violation of this sub-paragraph (ii) so long as the transfer price is determined based on the fair market price at the time of such disposal;
- (iii) The transferor should not have right to claim back the Securitization Assets, and the transferee should not have the right to claim back the price paid for the transferred Securitization Assets; and
- (iv) The transferee should assume risks associated with the Securitization Assets; provided, however, it is possible for the transferor to assume such risk for a specific period of time or to bear warranty liabilities (including the transferor's warranty for the obligor's financial capability)

### 3. Appointment of Servicer and Business Trustee

The SPC must appoint the Originator or other qualified servicer as its servicer ("Servicer") and entrust the servicing of the Securitization Assets. In addition, all of the businesses of the SPC other than those specifically listed in Article 23 should be entrusted to a third party (a "Business Trustee"). Such requirement is in line with the restrictions provided in the ABS Act on SPC's ability to hire employees. While only

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17) Article 6 of the ABS Act.

certain qualified entities may be act as a Servicer, there is no restriction as to the qualification of a Business Trustee. Nevertheless, in an asset-backed securitization involving public offering of Asset-Backed Securities, the FSC has been actually requiring that a financial institution should be appointed as a Business Trustee in order to protect the holders of the Asset-Backed Securities.<sup>18)</sup> The Servicer and the Business Trustee need not be separate entities.

#### 4. Issuance of Asset-Backed Securities

There is no mention as to the timing of the issuance of Aasset-Backed Securities in the ABS Act. However, since it is the normal practice for a securitization vehicle to fund the money required acquiring the Securitization Assets through the issuance of securities, it is quite common to have the acquisition of Securitization Assets and the issuance of securities occurring simultaneously.

#### *C. Qualifications of the Originator*

The Paragraph 2 of the Article 2 of the ABS Act lists certain entities as qualified Originators and such Originator may be largely classified into following categories:

1. financial institutions;
2. government owned public companies such as the Korea Asset Management Corporation (“KAMCO”), the Korea Land Corporation (“KOLAND”), the Korea National Housing Corporation, the National Housing Fund; or
3. corporations which are of international repute (including foreign corporations or Korean subsidiaries of foreign corporations) whose assets are deemed necessary to be securitized and approved in accordance with the prescribed standards by the FSC.

Currently, only these qualified Originators are entitled to securitize the assets owned by them. The purpose of such limitation on qualifications of the Originator is to

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18) Legally, the Business Trustee is only an administrative agent of the SPC and not a trustee for the holders of the asset-backed securities. However, as the term Business Trustee, which is a literal translation of the corresponding Korean term used in the ABS Act, implies, in practice, FSC has regarded and requires the Business Trustee to actually assume the duties of the holders' trustee and to protect the interest of the holders.

minimize the detrimental effects, which may be caused by the special privileges (see IV below), granted under the ABS Act.

#### *D. Qualifications of the Servicer*

Under Article 10 of the the ABS Act, only the following persons are entitle to act as SPC's Servicer.

- ( i ) The 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.

#### *E. Scope of Securitization Assets*

The ABS Act provides that “Securitization Assets” are to be defined as “debt claims, real estates and other property rights that are the subject matters of securitization”<sup>19)</sup>. While the qualifications of the Originator are rather limited, the scope of Securitization Assets is quite broad (almost without restriction). Nevertheless, since securitization involves the issuance of securities in return for future cash flows with respect to Securitization Assets, the Securitization Assets must be able to produce future cash flows. In this regard, it was the main issue during the process of legislative debate as to whether or not real estates should be included as a securitization asset, although it was later decided that real estates should be included. Such conclusion was based on the fact that many developed countries have permitted various types of assets to be securitized and also that, in particular, the Resolution Trust Corporation (“RTC”) of the United State has successfully securitized real estate assets.

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19) Paragraph 3 of Article 2 of the ABS Act.

## *F. ABS Securities*

### 1. Type of Securities

Under the ABS Act, the Asset-Backed Securities are defined as the “equity securities, debentures, beneficial certificates and other securities or certificates to be issued pursuant to a Securitization Plan in respect of Securitization Assets”.<sup>20)</sup> In such case, there is no restriction as to the scope of “other instruments or certificates”, which would mean that there is also no restriction on the type of the securities to be issued in a securitization transaction. However, the Asset-Backed Securities issued under the ABS Act may not automatically be recognized as ‘securities’ under the *Securities Exchange Act*. As a result, there may be certain inconveniences and hindrances as to the issuance and distribution of Asset-Backed Securities not recognized as securities under the Securities Exchange Act. Moreover, beneficial certificates issued by a trust company under the ABS Act would still be required to comply with the *Trust Business Act* despite the fact that such beneficial certificates will be treated as securities under the *Securities Exchange Act*. In the case of debentures, since they are not limited to debentures issued by *chusik hoesa* (which is the most common form of a limited liability company in Korea) under the *Securities Exchange Act*, it is possible that debentures issued by a SPC would be regarded as ‘debentures’ (therefore, as securities) under the *Securities Exchange Act*. However, with respect to equity securities or “other instruments or certificates” issued by a securitization vehicle, it would be difficult to treat them as ‘securities’ as they are not expressly stipulated in the *Securities Exchange Act*.

### 2. Limit on Amount of Issuance

The permitted total amount of issuance of Asset-Backed Securities is restricted to the total amount of the purchase price or the appraised price of the Securitization Assets.<sup>21)</sup>

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20) Article 2(4) of the ABS Act.

21) Article 33 of the ABS Act .

## IV. Special Provisions and Privileges under the ABS Act

### A. *Special Provisions on Assignment Procedures of Securitization Assets*

#### 1. Assignment of Debt Claims

The Korean Civil Code stipulates that for an assignment of debt claims, a notice to or consent of an obligor is required in order for such assignment to be effective as against such obligor.<sup>22)</sup> Further, in order for such assignment to be perfected as against all third parties, such notice or consent must bear a fixed-date stamp.<sup>23)</sup> Yet, the ABS Act provides special provisions in order to simplify the assignment procedures in that it would be quite burdensome, in terms of time and expense, to satisfy the above requirements in a securitization transaction where a multitude of obligors are involved.

Under the ABS Act, a notice required for the assignment of debt claims to be securitized (as a prerequisite for protection against an obligor) may be given not only by an assignor but also by an assignee. In a situation where the address of an obligor is unknown, such problem can be resolved by a deemed notice by way of public notice of the proposed assignment published in a major daily newspaper after having sent certified content mails twice or more. Furthermore, even if no such notice is given, the assignment could still be perfected as against all third parties (other than the obligor of such debt claim) if the assignment is registered with the FSC under the ABS Act.<sup>24)</sup> This means, so long as such assignment is registered with FSC, the assigned debt claims will not belong to the bankruptcy estate of the assignor nor will the creditors of the assignor be able to attach the assigned debt claims even if no notice is given to or consent from the obligor is obtained. Of course, if no notice is given to or consent from the obligor is obtained, such an assignment is not effective as against the obligor of the assigned debt claim so that if the obligor, being unaware of the assignment, pays to the

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22) Article 450 of the Civil Code.

23) Paragraph 2 of Article 450 of the Civil Code. Further, the term "Fixed date" used in this Article 450 is interpreted to mean the date appearing on a document which the related parties cannot arbitrarily alter. 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.

24) Article 7 of the ABS Act.



assignor, the assignee will not be able to collect from the obligor. Nevertheless, in most of the securitization transactions, the originator serves as the servicer of the securitization vehicle so that underlying debt claims are physically collected by the originator on behalf of the securitization vehicle even after the completion of the assignment. Therefore, in reality, the absence of notice to or consent from the obligor does not actually increase any risk. Therefore, in a quite number of securitization transactions which involved a great multitude of obligors of the underlying assets, only the registration with the FSC has been done and notice to or consent from the underlying obligors have been waived.

## 2. Assignment of Mortgage

Under Korean Civil Code, assignment of mortgage interest requires registration of the assignment in the real estate register kept by the relevant court. In a transaction where the Securitization Assets consist of great number of real estates scattered all over the country, this means registration with numerous courts of the relevant jurisdiction. This would be not only time consuming but also very expensive. Hence, for an assignment of mortgage interest, the ABS Act permits a securitization vehicle to acquire mortgage interests by means of registration of such assignment with the FSC without any further registration on the real estates register kept by the relevant courts.

## 3. True Sale

As noted in Paragraph 2 of Section III above, Article 13 of the ABS Act requires that a transfer of the Securitization Assets by an Originator to an SPC must be done in a certain manner. This means, if a Securitization Plan contemplates a transfer which is not in compliance with this Article 13, such Securitization Plan shall not be registered with FSC. This Article 13 further provides that if a transfer of the Securitization Assets is done in the manner provided in Article 13, such transfer shall not be deemed as a creation of security interest. The legal commentators generally agree that the legislative intent of this Article is to provide a safe harbor for Asset-Backed Securitizations meeting the above requirement to be regarded as a true-sale so that the Securitization Assets of such Asset-Backed Securitization could be completely

isolated from the bankruptcy risk of the Originator.<sup>25)</sup>

There are pros and cons of the legal implication of this Article 13 of the ABS Act. Considering the legislative intent, the Korean insolvency courts may simply respect the form of an Asset-Backed Securitization registered with the FSC and determine that ownership of the Securitization Assets belongs to a securitization vehicle and not to the insolvency estate of the Originator. If such position is taken by the Korean courts, then, once the Securitization Plan is registered with the FSC, such Asset-Backed Securitization will be free from a “true sale” risk. However, for the reasons discussed below, there is a possibility that Korean courts may not be bound by the Article 13 of the ABS Act or FSC’s decision that all requirements of Article 13 are satisfied. First of all, the ABS Act does not specifically provide that satisfaction of Article 13 requirements will override other laws such as Bankruptcy Act or other insolvency related laws.<sup>26)</sup> (These laws are collectively referred to as the “Insolvency Act” in this paper). In other words, Article 13 does not clearly provide that the court must find for a true sale even in the insolvency context if the Article 13 requirements are met. Second, the basic principle of the Insolvency Act is to give equal treatment to creditors of the same class, which is different from that of the ABS Act. Third, determination by the FSC that a certain transfer meets the requirements of the Article 13 of the ABS is made at the time of the registration of the Securitization Plan; however, the determination by the insolvency court will be made later on and in such determination, not only the factors existing at the time of registration of the Securitization Plan but the post-registration factors should also be considered. Under the circumstances, an argument may be made that Article 13 merely defines the meaning of “true sale” for the purposes of the application of the ABS Act and registration of the securitization plan thereunder and that it should not be construed that a “true sale” exists for all intents and purposes, even in an insolvency situation. If such an argument is accepted by the Korean insolvency courts, then the Korean insolvency courts may seek to determine independently whether the transfer is a true sale within the meaning of the Insolvency Acts even though a particular transfer has been determined by the FSC at the time of the registration of the Securitization Plan to satisfy the requirements of the Article 13 of the ABS Act. There

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25) Asset-Backed Securitization Research Group, Financial Innovations- ABS 384-385 (1999).

26) There are three different bodies of law governing insolvency in Korea; (i) Bankruptcy Act (ii) Company Reorganization Act and (iii) Composition Act.

is no express provision in the Insolvency Act or in any other law as to what constitutes a true sale nor is there any court precedent on the issue of the true sale in case of the seller's insolvency. Therefore, it is not entirely clear at the moment as to what factors will be actually considered by the court in order to determine a transfer of assets to a securitization vehicle as a true sale, if the court takes the latter position. Considering the basic principle of the Insolvency Act (i.e., fairness among creditors) and the major difference between a true outright sale and a secured loan, we can still presume that the factors taken into account by a Korea court would be similar to those factors considered by US courts, such as (1) risk of loss (2) benefit of ownership (3) post transfer control (4) the parties' intent and (5) accounting treatment.<sup>27)</sup>

Nonetheless, as FSC, when approving the registration of the securitization plan, reviews the relevant agreements and considers true sale issues, registration with FSC will probably be very persuasive for the Korean insolvency courts in an insolvency procedure and the Korean insolvency courts will be very cautious in recharacterizing the nature of the transfer as creation of security interest for an Asset-Backed Securitization registered with FSC, even if the Korean insolvency courts take the latter position. Therefore, it would be fair to say that the Article 13 of the ABS Act does perform the role of a "safe harbor" for Asset-Backed Securitization registered with FSC to a certain extent.

On the other hand, as the satisfaction of the requirements under Article 13 of the ABS Act is mandatory, for those securitization transactions which does not meet such requirements, the opportunity to be registered with FSC and enjoy the benefits of the ABS Act is deprived of. While it is definitely preferable to structure the transfer of Securitization Asset to a securitization vehicle as a true sale, prohibiting transactions not meeting the requirements of Article 13 seems to defeat the legislative purpose of the ABS Act to promote securitization. The fact that such transactions are more risky to the investors is not a sufficient ground to prohibit such transaction. The issue of whether to undertake the Originator's insolvency risk is something to be eventually

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27) For the factors considered by US Courts, see Roy B. True, *Risk and Insolvency Issues in Japanese Asset Securitization*, International Law and Politics, Vol. 28, 1996, at 548; Malcom S. Doris, *Bankruptcy Considerations, Structured Mortgage and Receivables Financing 1990*, Practising Law Institute Real Estate Law and Practice Course Handbook Series (355PLI/REAL 301), 314-320; Robert D. Aicher and William J. Fellerhoff, *Characterization of a Transfer of Receivables As a Sale or a Secured Loan upon Bankruptcy of the Transferor*, American Bankruptcy Law Journal, Vol. 65, 1991, at 186-194.

determined by the investors.<sup>28)</sup>

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

In order to protect the holders of the Asset-Backed Securities against insolvency of the servicer in securitization transactions, the ABS Act specifies duties of the servicer to manage the entrusted Securitization Assets separately from its own assets.<sup>29)</sup> Further, in the event of bankruptcy of the servicer, such Securitization Assets separately managed by the servicer will not constitute a bankruptcy estate of the servicer, and the securitization vehicle may request the servicer or the receiver of the servicer to deliver such Securitization Assets to the securitization vehicle.<sup>30)</sup> The same should apply as to the commencement of composition procedures under the *Composition Act* or reorganization procedures under *the Corporate Reorganization Act*. Any creditors of the servicer cannot enforce their 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*.

### *C. Miscellaneous*

For the purpose of securitization, where any real estate acquired in connection with disposal of non-performing assets of financial institutions or corporate restructuring are assigned to an ABS SPC, exemptions on certain administrative restrictions, procedures or other charges under various laws (including *the Urban Traffic Readjustment Promotion Act*, *the Housing Construction Promotion Act* and *the Foreigners' Land Acquisition Act*, etc) and other tax benefits<sup>31)</sup> will be granted.

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28) Asset-Backed Securitization Research Group, *supra* note 25, at 385-386

29) Article 11 of the ABS Act.

30) Article 12 of the ABS Act.

31) The Special Tax Treatment Prevention Act provides reduction or exemption of certain taxes such as registration tax, acquisition tax and special value-added tax, etc.

## VI. Certain Tax Issues related to ABS Transactions

### A. Corporate Income Tax by an SPC

Under the Corporate Tax Act, the taxable income of a corporation is subject to the corporate tax as follows: (i) the total corporate tax rate for the taxable income equal to or less than 100 million Won at 17.6%, comprised of the sum of 16% in corporate tax and surtax thereon (10% of corporate tax) and (ii) the total corporate tax rate for the taxable income more than 100 million Won at approximately 30.8%, comprised of the sum of approximately 28% corporate tax and surtax thereon.<sup>32)</sup>

As the Asset-Backed Securities are issued by the SPC either in the form of a debt securities or equity securities, the actual cash received by the holders of the Asset-Backed Securities would be classified as interest or dividend. Under Korean tax law, both interest and dividend are subject to withholding tax. Therefore, unless a special tax exemption is granted, the cash-flow arising out of the Securitization Assets will be subject to two level of income tax—once at the SPC level at 17.6% or 30.8%, as the case may be and a second time in the hands of the holders of the Asset-Backed Securities at the time of payment of interest or distribution of the dividends.<sup>33)</sup> Such two-level tax will substantially undermine the economic efficiency of the transaction. One way of practically avoiding two level taxation is through deduction by the SPC of the interest paid on the debt securities issued by the SPC, which offsets a corresponding amount of profit arising from the underlying Securitization Assets. In a case where the exact amount of the future income cashflow of the SPC can be calculated at the time of the issuance of Asset-Backed Securities, the interest rate of the debt securities issued by the SPC will be set at such rate so as to set off with all profits of the SPC with the interest so that net income of the SPC will eventually be almost zero. However, in a case where the future income cashflow is difficult to estimate in advance (for example, where Securitization Assets are non-performing

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32) Exact corporate tax amount for taxable income over 100 million Won is 16 million Won plus 28% of excess portion of the taxable income exceeding 100 million Won.

33) For a Korean corporation, withholding is waived in certain cases and even if it is withheld, it is only a timing issue because the Korean corporations are entitled to a tax credit for the amount of the withholding tax in calculating its corporate tax on its overall net income. However, for an individual holder or a non-resident holder, it is a critical issue.

loan, it would be almost impossible to estimate the exact amount of collection in advance), all or at least a certain portion of the Asset-Backed Securities will have to be issued in the form of equity securities in order to pass all of the cash-flows from the underlying Securitization Assets to the holders of the Asset-Backed Securities. As dividends are not deductible expenses under Korean tax law, a structure involving issuance of Asset-Backed Securities in the form of equity securities would be economically very inefficient. Considering the foregoing, the Corporate Tax Act provides a special tax benefits for Asset-Backed Securitization under the ABS Act. Under Article 51-2 of the Corporate Tax Act, if the ABS SPC distributes as dividend at least 90% of the distributable profits of such company as prescribed in the presidential decree, the amount of such dividend shall be deducted from its taxable income. Therefore, for an ABS SPC, the burden of the two-level tax is substantially reduced. However, it is important to note that the above-mentioned tax benefit for corporate tax is not available to an Offshore SPC. Thus, in a structure where issuance of equity securities is contemplated, using an ABS SPC would be a better choice to reduce tax liabilities of such SPC.

Further, theoretically speaking, the tax status of the Offshore SPC in connection with the corporate income tax may vary greatly depending on whether or not the Offshore SPC has a permanent establishment in Korea. If the Offshore SPC has a permanent establishment in Korea, it will be subject to the same corporate tax applicable to a Korean corporation on its overall net income. If, however, the Offshore SPC does not have a permanent establishment in Korea, its domestic source of income will be subject to withholding tax pursuant to the Corporate Tax Act; provided, however, the applicable tax rate will be subject to adjustment as provided in the tax treaty, if one exists, between the SPC's country of residence and Korea, potentially resulting in reduction or exemption of the corporate tax. Currently, however, as the FSC actually requires the Offshore SPC to establish a branch in Korea as a prerequisite for filing registration of a Securitization Plan, most of the Offshore SPCs do have a branch in Korea and thus, are considered to have a permanent establishment in Korea.

### *B. Tax Exemption under TPCL*

Most of the tax reductions and exemptions provided in TPCL are for securitization transactions involving real estate as Securitization Assets. Further, such tax reduction

and exemptions are available to ABS SPCs. Therefore, if the Securitization Assets involve real estates, the tax positions between the ABS SPC, i.e. a Korean SPC in the form of *yuhan hoesa*, and an Offshore SPC are significantly different.

### 1. Acquisition Tax

Under the Local Tax Act of Korea, acquisition tax is payable upon acquisition of certain types of assets as provided therein and one of such asset is real estate. However, TPCL provides that for a real estate acquired by an ABS SPC prior to December 31, 2003 the acquisition tax shall be exempt.<sup>34) 35)</sup>

### 2. Registration Tax

As noted above, a transfer of a real estate ownership or a transfer of a mortgage interest should be registered with the real estate registry. Further, such registration is subject to certain amount of registration tax. However, TPCL provides that for registration of transfer of ownership interest or mortgage interest in a real estate acquired by an ABS SPC prior to December 31, 2003, the registration tax are exempt

### 3. Capital Gains Tax

Under Corporate Tax Act, capital gains made by a company upon sale or disposition of a real estate is subject to the special additional tax, the nature of which is a capital gains tax. However, the special additional tax on capital gains from the disposition of real estate assets originally acquired by an ABS SPC in accordance with the ABS Plan filed under the ABS Act will be reduced by 50% provided that the relevant real estate assets were acquired by the ABS SPC from the originators before December 31, 2003 and such assets are disposed of within 5 years from the date of acquisition.<sup>36)</sup>

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34) Article 119 of the TPCL.

35) Article 120 of the TPCL.

36) Under Corporate Tax Act, when a real estate asset is disposed of, the seller pays two types of taxes: income tax and capital gains tax. The gains realized will be added to the taxable income so that an ordinary corporate income tax

## VI. Conclusion

Since securitization is, as in other countries, a form of advanced structured finance involving various parties, such as the originator, a securitization vehicle, the servicer, the business trustee, investors and credit evaluation company, it has been only possible in countries which have developed financial markets. It goes without saying that thriving securitization market is conditioned by complementary economic, social and legal framework. Securitization has been one of the most effective and appropriate method in solving current economic problems in Korea, such as restructuring of financial institutions and corporations, despite many defects found in the ABS Act (since it was enacted somewhat hastily to remedy the sudden economic crisis in Korea). With increasing demand for securitization in Korea, it is expected that as the experience and knowledge in relation to securitization are gained and accumulated progressively through trial and error, the ABS Act will further be improved by adding and/or modifying relevant provisions.

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(maximum 30.8%) will be imposed. The gain is calculated by deducting the property's book value (i.e. the acquisition basis less depreciation and other adjustments) from the selling price; however, such gains may be offset with the losses of the company. The capital gains tax (called, "special additional tax") is a separate tax on the gain only, which is calculated by deducting the property's acquisition cost (as compared to the book value) from the selling property. Losses do not offset gains in computing capital gains tax. While capital gains tax in the U.S. may imply preferential tax rates, the opposite is true in Korea if the capital gain is derived from the disposition of real property. The capital gain tax is an additional tax to the ordinary income tax, designed to discourage real estate speculation. However, in response to the down turn in real estate market, the government introduced a number of regulatory enhancements to revitalize the real estate market.