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Part 3 What is Structured Finance / Asset Finance?

- Fund / SPV-based financing

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Series Overview – 5 in total

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* This series is a digest of my book "**Finance Law - Fundamentals of Finance Law and Essentials of Advanced Financial Transactions**" (Shoji-Homu, 2016). In the text, "the Book" refers to this book.

1. What is Structured Finance / Asset Finance?

In part 3 of this series, the theoretical basis of (a) **Non-recourse financing**, which is a fundraising method developed to avoid the disadvantages and risks of **corporate finance** (see "Part 2: What is Corporate Finance? - Taking into account the distinction between debt and equity"), and (b) funds used in **asset management**, etc. which is the practice of investment management (explained in Part 4 of this series) will be examined from a legal point of view. Typical examples of non-recourse financing are **structured finance** (financial transactions which incorporate a certain structure) and **asset finance** (a method of lending funds based solely on specific assets).

Non-recourse finance is a financing method that addresses the disadvantages of corporate finance, such as (i) the possibility and ease of assessing asset value, (ii) the possibility and ease of assessing debt value, and (iii) the competitive nature of collection (see "Part 2: What is Corporate Finance? - Taking into account the distinction between debt and equity").

The first legal feature is that **the scope of assets that investors reserve is limited to specific assets** in order to deal with (i) the possibility and ease of assessing asset values (**2-1 and 2-2** below). In non-recourse finance, investors select only those assets that can be investigated and judged to have substantial economic value out of the total assets of the fundraiser and make investment decisions focusing only on the possibility of recovery from such assets. In **non-recourse finance**, instead of limiting the liable assets to specific businesses or assets to be underwritten by investors (fund providers), such businesses or assets are set aside only for such investors (fund providers), subject to the consent of other creditors. In this respect, it is distinguished from corporate finance where the total assets of the fundraiser are the liable assets, while other investors and creditors to the fundraiser also reserve the total assets of the financier.

The second legal feature is the use of a **fund** with an **SPV** as its component to address (ii) the possibility and ease of assessing debt value and (iii) competitiveness of collection (**2-3 and 2-4** below). SPVs are used (i) in the **fundraising** context to transfer a specific business or asset that constitute part of the ultimate fundraiser's total assets from the **originator**, who is the ultimate funder to form an investment structure that is not subject to the final financier's credit risk; and (ii) in an **investment management** context, SPVs are used to separate certain securities or other assets that are the subject of the investor's investment from the assets of the **fund manager** that specializes in the management of the investor's funds, in order to create an investment structure that is not subject to the credit risk of the fund manager.

2. Structured Finance / Fundamentals of Asset Finance

2-1. The concept of Liable Assets

Under the Civil Code, liability is defined as a certain amount of assets being an allowance for an obligation, or in other words, a certain amount of assets serving as collateral for the satisfaction of a claim in the event that the obligation is not performed. In this text, **liable assets** are defined (more broadly) as **assets that serve as an allowance for the recovery of the investor's investment.**

Under the General Provisions of the Civil Code, it is not possible to subdivide property rights (the object of private rights) by department, business, or type of assets within a legal entity (the subject of private rights). If the fundraiser does not repay the investment amount, the debt investor will attempt to recover it by acquiring and converting the fundraiser's property through compulsory execution, etc., however, in principle, the assets to be set aside for this purpose (liable assets) should be the same as all the assets belonging to the legal entity of the fundraiser (**total assets**).

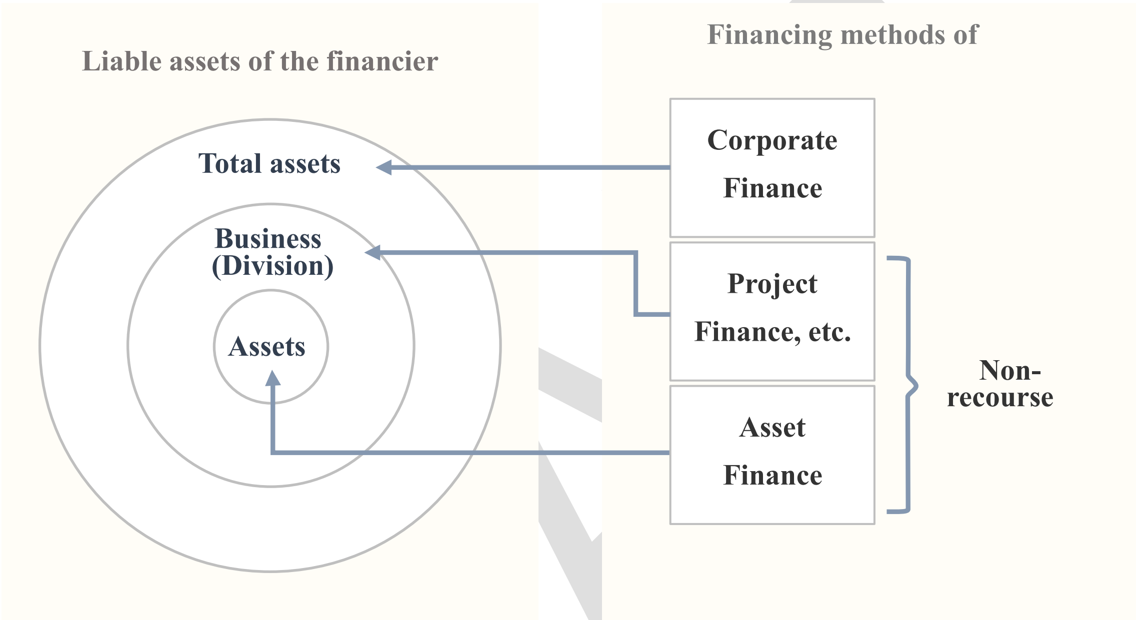
There are also **specific businesses and assets** of the fundraiser that could theoretically exist within the scope of liable assets, and in practice, some **structures** are often used to intentionally create such liable assets based on special laws or agreements between the parties. Such **structures** include (i) the use of a **limited liable assets covenant** (a covenant based on an agreement between a specific creditor and a debtor in which only the specific business or assets of the creditor are liable assets **in relation to the creditor**) and (2) **the transfer of business or assets to an SPV (fund)**. In the latter case, ownership of the specific business or assets is legally separated (transferred) from the fundraiser and the SPV is used as the new entity to which the business or assets belong (referred to as “**transfer type**” in the Book).

In the case of a new business, the SPV itself, which was established for the sole purpose of its operations may start the new project (referred to as “**independent project type**” in the Book), rather than transferring this to the SPV after the fundraiser starts the business.

2-2. Scope of Liable Assets and Non-Recourse Financing

Non-recourse financing is possible by utilizing certain legal systems and structures described above and by flexibly setting the scope of liable assets. This realizes one of the most essential elements in finance, namely, control of credit risk (**credit engineering**), and finance methods are classified in a corresponding manner.

【Figure 3-1: Scope of Liable Assets and Financing Methods】



【Figure 3-1】 shows the general relationship between the scope of liable assets and financing methods that could theoretically exist. First, the scope of liable assets of the fundraiser largely includes (i) total assets, (ii) specific businesses (or divisions), and (iii) specific assets. Second, the financing methods of the funder include (a) **Corporate Finance** which reserves the total assets of the funder (see "Part 2: What is Corporate Finance? – Taking into account the distinction between debt and equity"), (b) **Asset Finance** which reserves specific assets of the fundraiser, and (c) **Project Finance** which reserves the fundraiser's business as an intermediate type of the above. Of these, Corporate Finance is a financing method in which the entire assets of the fundraiser are (ultimately) liable assets (**Full-Recourse Finance**), whereas Asset Finance and Project Finance are generally financing methods where only the specific assets or businesses of the fundraiser are liable assets (**Non-Recourse Finance**).

2-3. SPVs

SPV stands for **Special Purpose Vehicle** and refers to an instrument established or created to realize a special purpose. It is established or set up to separate specific businesses or assets which are the liable assets from the total assets of the parties involved and legally to be vested in.

It should be noted that if (i) in the event the originator or fund manager is subject to insolvency proceedings and the liable assets attributable to the SPV or its cash flow are affected, investors would continue to bear the credit risk of these related parties. To avoid this, finance transactions using SPVs need to be insulated from the impact of the bankruptcy of related parties. In the fundraising context, this is called **bankruptcy isolation from the originator**.

In addition, (ii) if the SPV itself were to be subject to bankruptcy proceedings, the cash flow to be paid to investors would be impaired, and investors would need to consider the credit risk of the SPV. To avoid this, finance transactions using an SPV must be insulated from the impact of the SPV's bankruptcy (**bankruptcy isolation of the SPV**).

An SPV (in the narrow sense) must have **a function of an independent entity to which rights and obligations belong**. Companies and trusts are the entities that fulfill the conditions of an SPV in this sense.

(1) Companies (SPC)

A company used as an SPV is called a **Special Purpose Company** (**SPC**) or **Special Purpose Vehicle**. There are two types of SPCs: (i) companies established exclusively for investment under special laws and (ii) companies under the Companies Act that are used as SPVs. Representative examples of the former (i) are "Tokutei Mokuteki Kaisha" (**TMKs**; it means special purpose company) established under the Law on Securitization of Specified Assets by Special Purpose Companies (**SPC Law**) and investment corporations (**REITs, etc.**) established under the Act on Investment Trusts and Investment Corporations (**Investment Trust Act**). A representative example of the latter (2) is a **Godo Kaisha** (**GKs**; it means limited liability company).

(2) Trusts (SPT)

A trust used as an SPV is called a **Special Purpose Trust (SPT)**. There are also two types of SPTs: (i) trusts established exclusively for investment under special laws and (ii) trusts under the Trust Act, the general law on trusts, that are used as SPVs. Typical examples of the former (i) are special purpose trusts (**TMS**;

Tokutei Mokuteki Shintaku) established under the SPC Law and **(narrowly defined) investment trusts** established under the Trust Act.

2-4. Funds

(1) What is a fund?

Generally, a fund is defined as **a structure** that collects **investments and contributions such as money** from others, conducts some kind of **business or investment** using the money, and **distributes the income, etc. generated from the business or investment to investors**. Here, a **fund** is defined as the entire structure for distributing the income, etc. generated from investments to investors, which is composed of the following fund components: (i), (ii), (iii), (iv), and (v).

(i) Monetary investment and contribution (**equity investment**)

(ii) **Debt investment** (if any) used in conjunction with (i) above
→In many cases, equity investment (i) and debt investment are used together in funds to improve investment efficiency.

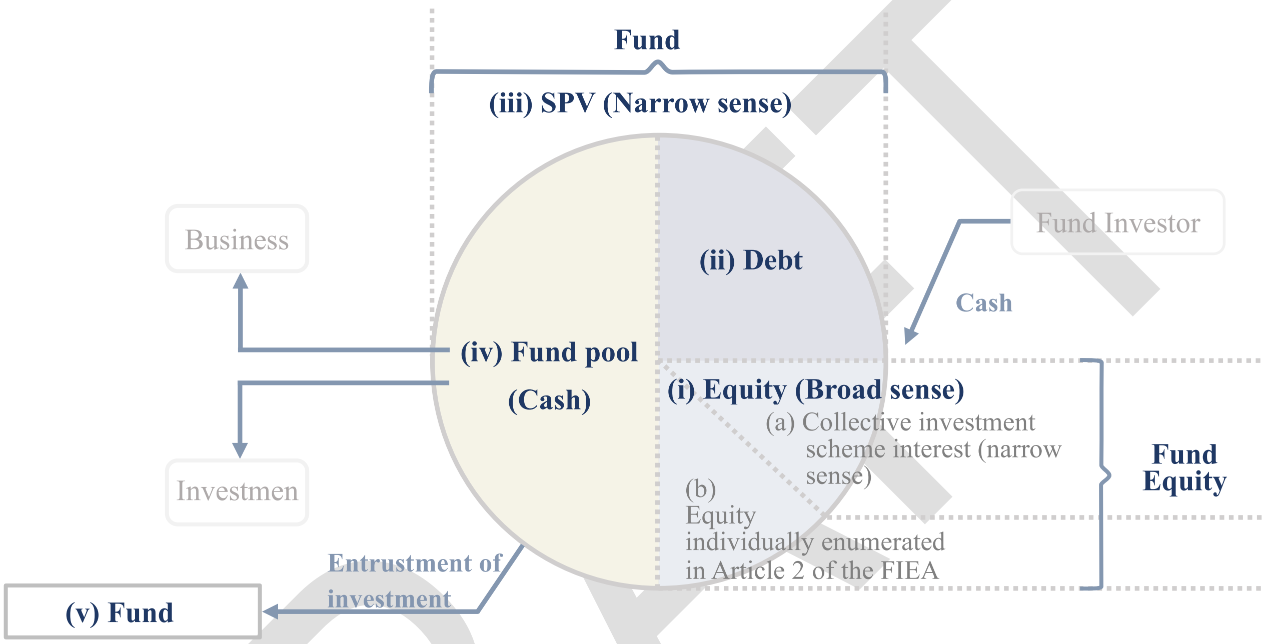
(iii) **SPVs** that are the investee (attributed party) of (i) and (ii) above and also the attributed party of (iv) and (v) below.
→SPVs in this sense include both **corporate-type** SPVs and **trust-type** SPVs. In this article, **partnership-type vehicles** are organized as a combination of an SPV and a partnership-type equity investment.

(iv) **Pools of funds** based on (i) and (ii) above or **investment assets** derived from such pools

(v) **Fund managers** who manage the pool of funds based on (i) and (ii) above.
→Funds are structured to distribute investment returns to equity investors, but investment analysis and investment management by fund managers **(information production function**) are required for the investment to practically generate income and other benefits.

Based on the above, **【Figure 3-2】** shows the relationship between the components (structure) of funds and various related concepts.

【Figure 3-2: Fund Components (Structure) and Concepts】



Equity investments by multiple investors in a fund are generally referred to as Collective Investment, and as the structure is also commonly referred to as a scheme, a fund is also called a **Collective Investment Scheme** (**CIS**) (broad sense). Correspondingly, equity investment interest in a fund is referred to as **fund interest** or **collective investment scheme interest (broad sense)**.

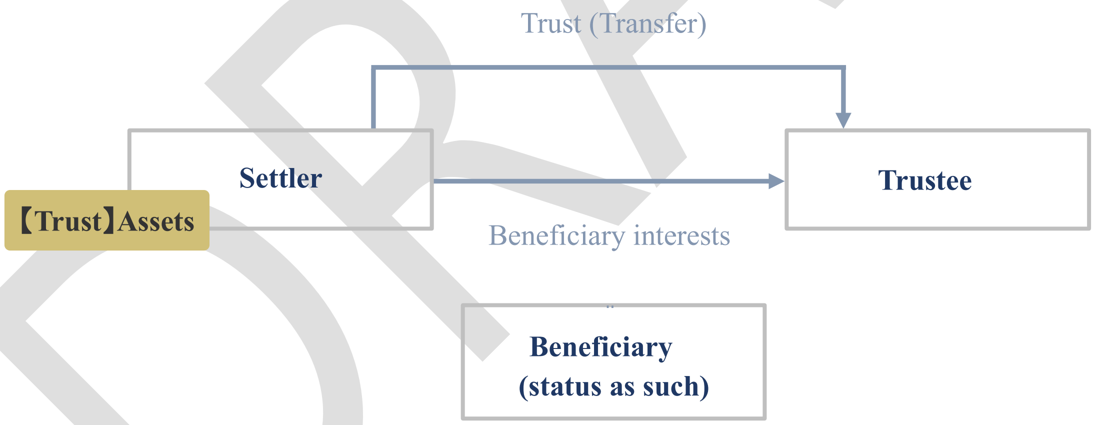
(2) Types of fund management: liquidation type and management type

In fund management, it is important to distinguish between the liquidation type and management type. The **liquidation type** refers to a method in which the assets or business (liable assets) to be invested in are first identified, and then investments are solicited from investors. As the assets are identified prior to investment, this financing method is called "(Specified) assets first". Typical examples of liquidation type funds based on special laws are TMK and TMS. On the other hand, the **management type** refers to a method in which investors entrust the fund manager with investment management without specifying the assets or business (liable assets) to be invested in. As investment is made prior to the identification of the assets, this method of financing is known as "Money first". REITs and mutual funds are typical examples of managed funds under the special law.

2-5. Trusts

A **trust** is a system provided for in the Trust Act and is defined as that under which (i) a specific person (**settler**) should, (ii) in accordance with a certain purpose (**trust purpose**), (iii) manage or dispose of property (**trust property**) and perform other acts necessary to achieve the said purpose. The specific person who manages or disposes of the trust property in accordance with the trust purpose is called the **trustee**, the other party to whom the trustee is obligated to manage or dispose of the trust property is called the **beneficiary**, and the rights that the beneficiary has against the trustee are called **trust beneficiary interests** or simply beneficial interests. Based on the above, **【Figure 3-3】** shows a diagram of the relationship between the parties to a trust.

【Figure 3-3: Relationship diagram of the Trust Parties (Summary)】



Trusts were originally developed as a system for asset management, but in modern times they are increasingly used as funds.

3. Various Structured Finance/Asset Finance Transactions

Specific examples of structured finance and asset finance, which are representative examples of non-recourse financing, include **acquisition finance (LBO)**, **securitization**, and REITs, in addition to project finance (see Chapter 9 of the Book).

This concludes the explanation of structured finance/asset finance. In the next part, **asset management** will be explained.