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Shining a Light on Special Purpose Entities in Ireland

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Shining a Light on Special Purpose Entities in Ireland

Brian Golden & Patrick Hughes¹

Special Purpose Entities (SPEs) form a substantial component of the Irish-resident financial sector and play an important role in risk dispersion within the global financial system. They are, however, quite complex, spanning a wide range of activities and often forming part of cross-border, multi-entity corporate structures. More generally, market-based credit-intermediation is increasingly supplementing and substituting traditional models of credit, where a company or household borrows directly from a bank which bears the risk of the loan (IMF, 2016). Ireland has emerged as a global hub for this activity, having a non-bank financial sector with total assets of €4.5 trillion in Q1 2018, of which €676 billion were held by SPEs.²

This paper's primary purpose is to outline the activities of the SPE sector in Ireland. The insights are primarily gathered from granular data collected by the Central Bank of Ireland (hereafter the Central Bank), which covers each SPE's balance sheet, mostly at individual security level, its activity type and links to other entities, among other information.³ We provide a broad overview of the sector, detail elements of interconnectedness to other financial entities, highlight some common business models and discuss the impact on the Irish economy.

1. What is an SPE?

For the purposes of this letter, we define an SPE as a legal entity, with little or no physical presence and narrow, specific, and/or ring-fenced, objectives, such as the segregation of risks, assets and/or liabilities, or as a cash conduit.⁴ The directors of an SPE typically have limited or no discretionary powers; rather activities are

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² Apart from SPEs, the main components of market-based finance resident in Ireland are investment funds and money market funds, with total assets of €2,380 billion and €499 billion respectively in Q2 2018. Domestic entities own less than 9 and 6 per cent of the shares/units of these sectors respectively. Furthermore, these shares are, to a significant extent, fund cross-shareholdings, i.e. funds holding shares/units in other funds, further emphasising the global nature of Irish-resident market-based finance. These data are taken from the Quarterly Financial Accounts, Investment Funds, Money Market Funds and Special Purpose Entities sections, available at the following link:

<https://www.centralbank.ie/statistics/data-and-analysis>

³ For more details see: <https://www.centralbank.ie/statistics/statistical-reporting-requirements/financial-vehicle-corporations> and <https://www.centralbank.ie/statistics/statistical-reporting-requirements/special-purpose-vehicles>.

⁴ The term "Special Purpose Entity" may be used interchangeably with the term "Special Purpose Vehicle". There is no distinct difference, though some terminology is more common in particular geographic locations. We use the term "SPE" to refer to all SPEs, "Securitisation SPEs" for this distinct subset and "Other SPEs" for the subset of non-securitisation SPEs.

The insights are primarily gathered from granular data collected by the Central Bank

An SPE is a legal entity, with little or no physical presence and narrow, specific, and/or ring-fenced, objectives

strictly defined by the terms of the SPE contract or arrangement. An SPE is often, though not exclusively, a satellite company of another financial entity and forms an ancillary part of the associate entity's business by warehousing particular assets or risks.

SPEs are usually divided into two main subtypes, which carry a range of associated terminology. These are;

1. Securitisation SPEs – or Financial Vehicle Corporations (FVCs)⁵.
2. Non-securitisation SPEs (“Other SPEs”).

Despite the significant role played by SPEs in international finance, no common accepted definition has risen to prominence among the international community of policy makers and regulators. Currently both the ECB and IMF have established technical groups to attempt to successfully define the perimeters of the entity type while the OECD is also active in this area. These efforts are on-going.

Some key definitions and concepts relating to SPEs are:

Sponsor: the entity on whose behalf an SPE was established. This is usually the ultimate beneficial owner of the SPE.

Originator: the entity that originally issued the loans/assets that have been repackaged in an SPE. For example, if an SPE purchases a portfolio of bank loans from the asset management company that decided to establish the SPE, then the bank is the originator and the asset management company is the sponsor.

Bankruptcy remoteness: an SPE is bankruptcy remote if the assets and liabilities are ring-fenced from their sponsoring entities. This means that the sponsor entity has no recourse to the assets of the SPE, and, conversely, if the SPE is unable to meet its obligations, then the sponsoring entity cannot be held accountable for the liabilities of the SPE.

Guarantor: alternatively, an SPE may be in receipt of a guarantee that it will meet its obligations. The guarantor is the entity that undertakes to meet the financial obligations of an aspect of the SPE's business.

Profit Participation Note/Loan: an instrument whose holder participates directly in the profit and losses of the SPE. Accordingly a share of all profit and/or losses, usually both realised and unrealised, transfer to the holder of the PPN or PPL.

Maturity transformation: occurs where a pool of securitised assets have a different maturity profile from the debt securities issued by the SPE. For example, an SPE issues debt securities with a maturity of one year. However the pool of assets which back the security are long-term loans. In one year's time when the debt securities mature, new notes will have to be re-issued, otherwise the SPE may not be able to pay the originator. Maturity transformation carries various risks including a risk that market appetites will have changed by the time the roll-over of the debt securities takes place.

⁵ Securitisation SPEs are referred to as “Financial Vehicle Corporations” in ECB statistical aggregates.

Consolidation: is when an SPE is incorporated into the balance sheet of another entity for financial regulatory reporting. This usually occurs where the entity has a risk or liability arising from its relationships with the SPE, and is an authorised legal entity.

Credit risk transfer: loans and other debt carry a risk that the debtor will not be able to repay the loan and will therefore default, called “credit risk”. In the process of securitisation, the risk of default is borne by the purchaser of the debt securities of the SPE and so the credit risk is transferred from the originator.

1.1 Securitisation SPEs

Securitisation is the process of issuing new transferable securities backed by existing assets such as loans, mortgages, credit card debt or other assets, e.g. accounts receivable.

Securitisation generally has two distinct components. Firstly, a company identifies assets and associated risks that it wants to remove from its balance sheet, packages them together and transfers ownership to an SPE. This pool of assets generates a cash flow, and these assets are most commonly some form of debt, such as loans or mortgages.

Secondly, the SPE issues transferable securities, normally bonds, that are backed by the newly-acquired assets and sells these securities to investors. The SPE normally issues a number of different debt securities, in tranches with varying credit quality.⁶ The SPE uses the proceeds of these sales to pay the company for the assets. The investor receives regular payments of interest but also takes on the risk of default associated with the assets. The pool of assets in the SPE are normally difficult to trade while the debt securities issued by the SPE are usually more liquid.

Securitisation SPEs contain a number of sub-categories, determined by the types of assets that underpin the cash flows (Table 1).

Table 1: Securitisation activity types

Vehicle Type	Securitisation SPE Activity Description
RMBS	Residential Mortgage Backed Securities are financial instruments which are loan-based and secured upon residential property.
CMBS	Commercial Mortgage Backed Securities are financial instruments which are loan-based and secured upon commercial property.
Consumer ABS	Consumer Asset Backed Securities are financial instruments which are loan-based and secured upon consumable products, such as automobiles, and where the debtors are private individuals.
Corporate ABS	Corporate Asset Backed Securities are financial instruments which are loan-based and secured upon consumable products, such as automobiles, and where the debtors are corporations.

⁶ Tranches are tiers of debt security that create a cascading risk profile, where in the instance of default, the subordinate tranches suffer losses until their value is completely eroded and senior tranches are last to suffer losses in the event of default.

Cash CDO	Collateralised Debt Obligations. These are pooled assets of various types of loan that act as collateral for the CDO. The CDO assets are brought onto the balance sheet of the FVC.
Synthetic CDO	Collateralised Debt Obligations. The FVC gains exposure to the assets through credit derivatives but does not take the assets themselves onto its balance sheet. This is a form of synthetic securitisation.
Lease Securitisation	Vehicles where the primary assets are lease agreements, typically on aircraft or other operating equipment, including EETC (Enhanced Equipment Trust Certificate) and Portfolio Securitisation.
ABCP Programme	Asset-Backed Commercial Paper vehicles are conduits which issue debt based on commercial paper purchased from other vehicles or third parties.
Multi-Issuance Vehicle	Similar to an ABCP structure; however these vehicles have a ring-fencing element whereby the security granted over particular assets is restricted to the holders of specified classes of notes.
Receivables	Vehicles engaged in trade receivables securitisation.
Other	Any FVC which does not fit within one of the above vehicle types.

1.2 Other SPEs

Other SPEs, i.e. SPEs not engaged in securitisation, have a much wider range of functions. The key distinction from securitisation SPEs is that credit risk does not pass to purchasers of loans or debt securities issued by the SPE. There is no specific model for other SPEs though most issue debt securities or loan instruments. In a small number of cases, they are merely cash conduits. Other SPEs self-categorise into one of fourteen distinct varieties (Table 2).

Table 2 Other SPE activities.

Vehicle Type	Other SPE Activity Description
Intra-Group Financing	Loan funding from, and to, intra-group companies.
External Financing	Funding obtained from external sources and provided to the parent as a loan.
Fund-Linked Asset Management	Linked to investment funds/firms, which hold debt, equity, loans, or other financial assets with the goal of capital appreciation, interest or dividend income.
Loan Origination	Funding obtained from the parent and furthered to external sources.
Operational Leasing	Hold fixed assets such as plant and machinery for the purposes of leasing them out.
Resolution vehicles	Set up by national authorities to resolve insolvent financial institutions (incl. NAMA).
Bank-Linked Asset Management	Linked to deposit taking corporations, which hold debt, equity, loans, or other financial assets with the goal of capital appreciation, interest or dividend income.
Receivables Financing	Funding secured by trade/other receivables, furthered to the parent/external sources.
Repackaging	The proceeds and/or capital gains/losses from the SPV's financial assets are structured so that investors obtain different exposure than had they simply purchased the assets.

Client Managed Account	Set up by financial institutions on behalf of clients which hold debt, equity, loans, or other financial assets with the goal of capital appreciation, interest or dividend income.
Insurance-Linked Investments	Primarily hold Insurance-Linked Securities such as catastrophe bonds, or investments in life settlement policies.
Financial Leasing	Engaged in lease-in lease-out agreements, or as a financial intermediary in a chain of vehicles in which the end vehicle is involved in the leasing of equipment or fixed assets.
Holding Company	Owns enough voting stock in another company to control its policies and management and exists for this sole purpose.
Other Financial Investments	Not linked to banks, client accounts, or investments funds/firms, but hold debt, equity, loans, or other financial assets with the goal of capital appreciation, interest or dividend income.

2. Benefits and Risks

Securitisation and other activities listed in Table 2 can provide benefits to the wider economic and financial system, though not without risk.

Securitisation, by transferring credit risk to the holders of debt securities, can reduce the concentration of risk within the wider financial system by distributing the risk across a wide range of investors. Securitisation opens up additional funding channels for the sponsoring entity by transforming illiquid assets into cash. This process allows bank sponsors to engage in further lending while non-bank sponsors have access to a source of market-based finance. Therefore, securitisation supports lending in the wider economy beyond what bank balance sheets could otherwise sustain. The promotion of securitisation activity is a key part of the EU Capital Markets Union initiative, given the strong dependence of the EU economy on bank finance relative to the US.

Risks can materialise and have systemic consequences, however, as was observed when securitisation activity froze in 2007. A sharp increase in risk aversion was driven by opacity surrounding highly complex contracts underpinning debt issuance and a lack of confidence in the ratings of securitised debt (BIS, 2009). The impact was systemic when the value of securitised debt depreciated sharply, due to deteriorating underlying asset quality and the lack of a liquid market. In particular, many banks had substantial holdings of securitised debt, while other banks became dependent on securitisation for funding. These risks have been subject to significant policy mitigation measures in recent years, including tightened bank regulations and some retention of risk by the FVC originator, a mechanism which helps to align incentives. Furthermore, market participants know the extent to which the securitisation market can freeze, as was not the case pre-2007. Nevertheless, sponsor dependency on SPEs remains a risk. Furthermore, securitised debt tends not to be as liquid as many other forms of debt securities, which may increase the likelihood of the sector acting pro-cyclically at times of

Securitisation, by transferring credit risks to the holders of debt securities, can reduce the concentration of risks within the wider financial system

These risks have been subject to significant policy mitigation measures in recent years

market stress or the materialisation of risks in some FVCs impacting the whole sector.^{7,8}

Non-Securitisation SPEs, though not transferring credit risk, are engaged in a wide range of activities that support banks and firms in various ways. SPEs can facilitate the raising of debt funding from external investors, loan provision to external sources or, indirectly, by acting as part of a wider credit intermediation chain.⁹ Risk sharing can also be facilitated, where returns are distributed between various participants, tailored to their specific risk appetite. More generally, SPEs can provide an efficient structure for the conduct of business activities across borders.

Each of these benefits carries an element of risk. Credit intermediation and risk sharing may become dependent on the availability of certain SPE structures and tax and/or regulatory incentives. Technical changes in rules governing the tax or regulatory treatment of SPEs could potentially have a sudden impact on this, or another, jurisdiction. More generally, SPEs could potentially be employed to achieve levels of tax efficiency or take advantage of legal opportunities to engage in regulatory arbitrage that may not be aligned with society's wider interest. Uncertainty surrounding these risks is exacerbated by SPEs often forming part of complex cross-border corporate structures and opacity surrounding the activities of non-securitisation SPEs globally. In jurisdictions like Ireland, where SPEs interact extensively with non-resident parties, many of these risks could be reputational in nature, e.g. where the activities of resident SPEs lead to a negative impact in another country or countries, leading to criticism of the framework in the SPE host country.

Uncertainty surrounding these risks is exacerbated by SPEs often forming part of complex cross-border corporate structures and a remarkable degree of opacity

3. Legal and Regulatory Background in Ireland

Given the lack of an internationally accepted definition, SPEs tend to be subject to differing rules and treatments in different jurisdictions, though in practice this increases the risk that SPEs are engineered to minimise regulatory oversight. SPEs are typically not authorised by financial regulators, but where the sponsor or originator is a regulated entity, the SPE is often consolidated into the balance sheet of that entity by the home regulator¹⁰.

In Ireland, SPEs are not authorised by the Central Bank and are not subject to prudential regulation, though they are subject to local and international laws. A non-exhaustive list of applicable rules that impact on SPEs in Ireland are:

- SPEs must register with the Companies Registration Office and are subject to company law, which, in most instances, includes such requirements as filing annual accounts, recording directors, etc;
- SPEs that trade in derivatives are subject to European Markets Infrastructure Regulation (EU/ 648/2012) and must report derivatives positions to trade repositories;

⁷ For example, securitised debt is considered relatively illiquid under Basel 3 banking regulation compared to, for example, investment-grade sovereign debt.

⁸ See, for example, BIS (2011), p. 10, linking the crisis with pro-cyclicality of securitisation.

⁹ Credit intermediation is the process of receiving funds in order to provide debt financing to another party or parties.

¹⁰ A home regulator may be defined as the regulator of the sponsor entity in the jurisdiction in which it is authorised. For example, if an SPE was established in Ireland by a French bank, the SPE may be consolidated into the balance sheet of the French bank by the French Regulator.

- SPEs that issue securities on a regulated market may be subject to the Transparency Directive (2004/109/EC), which imposes certain disclosure requirements;
- The Prospectus Directive (2003/71/EC) may apply to SPEs that issue securities on a regulated market or to the public. This requires the SPE to issue a prospectus detailing the risks associated with the security to be marketed;
- SPEs that carry out certain activities as set out in section 24 and Schedule 2 of the Criminal Justice (Money Laundering and Terrorist Financing) Act 2010 are obliged to comply with Anti-Money Laundering and Countering the Financing of Terrorism obligations as set out in that Act. In addition, such entities are obliged to register with the Central Bank following the commencement of the Criminal Justice (Money Laundering and Terrorist Financing) Act 2018, which was signed into law on 14 November 2018;
- The Securitisation Regulation will come into effect in the EU on 1 January 2019. The Securitisation Regulation introduces a common rulebook for all securitisations and establishes the concept of a simple, transparent and standardised (STS) securitisation into EU law, amending the capital requirements associated with STS-branded securitisations. The Regulation also prohibits re-securitisation, so that securitised assets cannot be used as underlying assets in new securitisations, without prior approval of a competent authority.

In addition, the Central Bank has introduced statistical reporting requirements for SPEs. Securitisation SPEs are governed by regulation ECB/2013/40 (often referred to as Financial Vehicle Corporations, or “FVCs”) for statistical purposes, and must report quarterly balance sheet data to their National Central Bank (“NCB”), as from Q4 2009 (Central Bank of Ireland, 2011). The Central Bank imposes additional data requirements, such as details on the characteristics and structure of the entity.

Since Q3 2015, most other SPEs report the same data as securitisation SPEs to the Central Bank. The Central Bank imposed these requirements on other SPEs availing of Section 110 of the Taxes Consolidation act, 1997 (“S110 Companies”)¹¹ as a practical measure, to define the reporting population. While there are some non-securitisation SPEs outside of S110, industry sources suggest that the majority of such entities are captured, given the tax advantages (Central Bank of Ireland, 2016). All securitisation SPEs, whether S110 companies or not, are captured.

4. Overview of Sector

Ireland, as a major channel for global market based financial flows, has the largest securitisation SPE sector in the euro area by assets under management (AUM) and is one of the main global hubs for other SPEs.¹² In Q2 2018, the Central Bank collected granular data from 2,170 SPEs, with AUM of €685 billion. This is broken down into 1,049 securitisation SPEs with AUM of €417 billion and 1,121 other SPEs with AUM of €269 billion.

Ireland, as a major channel for global market based financial flows, has the largest securitisation SPE sector in the euro area

¹¹ Section 110 is a provision under Irish tax law where SPVs that meet the qualifying criteria can avail of a special tax regime.

¹² According to ECB statistics for June 2018:

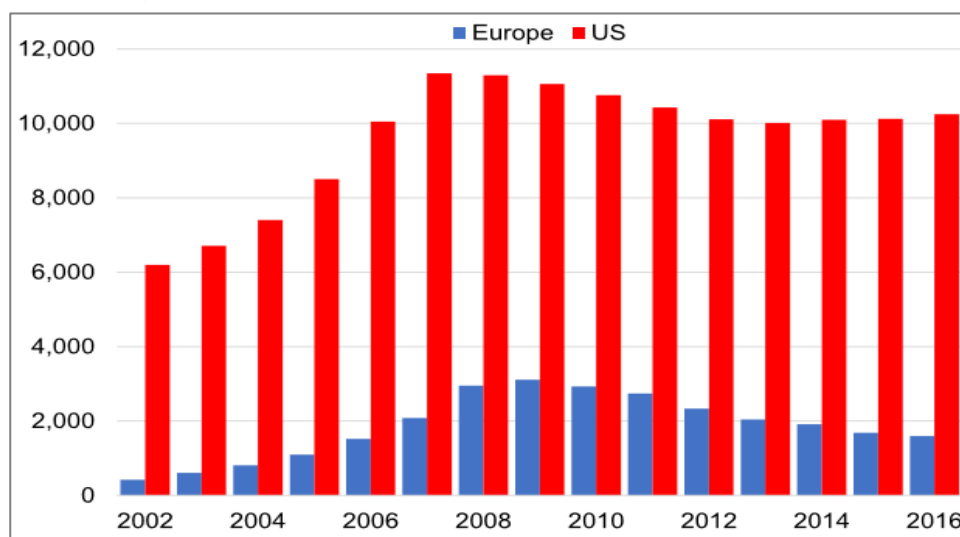
<http://sdw.ecb.europa.eu/reports.do?node=1000003622>

4.1 Overview of Securitisation SPEs

Securitisation activity has expanded steadily in recent years, though not to levels observed before the financial crisis. The nature of securitisation has also evolved.

Reflecting international trends (Chart 1), securitisation activity became increasingly prominent in the years up to 2007. In Ireland, this activity focused primarily on mortgage backed securities (MBS) and collateralised debt obligations (CDOs).¹³ During the crisis, retained securitisation by banks was the only prominent activity, whereby a bank pools assets into an SPE and then subsequently buys the notes issued by that SPE. These SPE issued securities met collateral requirements to access ECB emergency liquidity facilities, whereas the underlying assets did not.¹⁴ Other securitisation activity was almost completely curtailed and assets under management (AUM) gradually reduced as debt underpinned by MBS and CDOs matured and SPEs were wound down. Additionally a small number of very large vehicles were set up to warehouse distressed mortgage loans, including SPEs established on behalf of NAMA.

Chart 1: Securitisation in Europe and the United States (outstanding figures, USD billion)

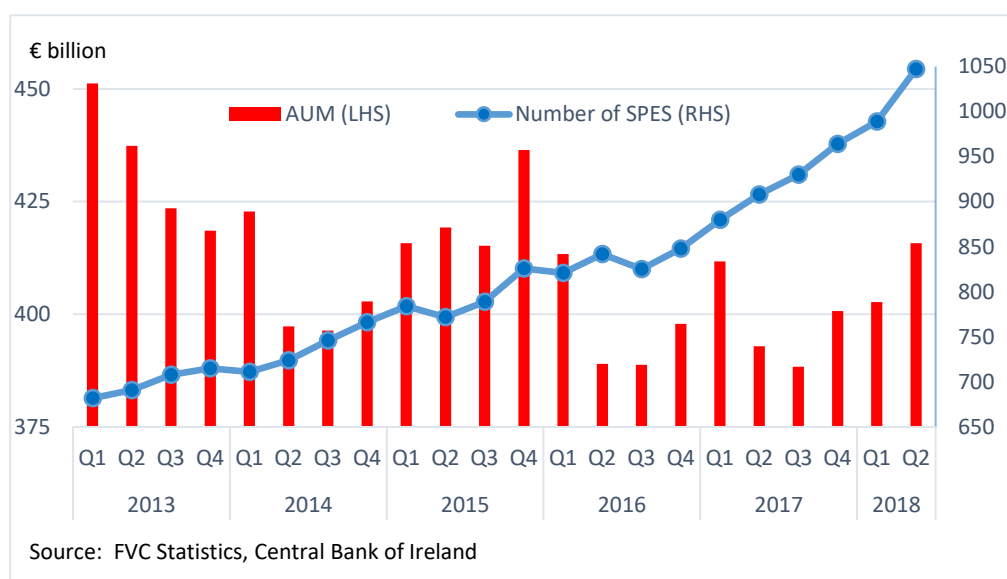


Sources: Association for Financial Markets in Europe (AFME) and Securities Industry and Financial Markets Association (SIFMA)

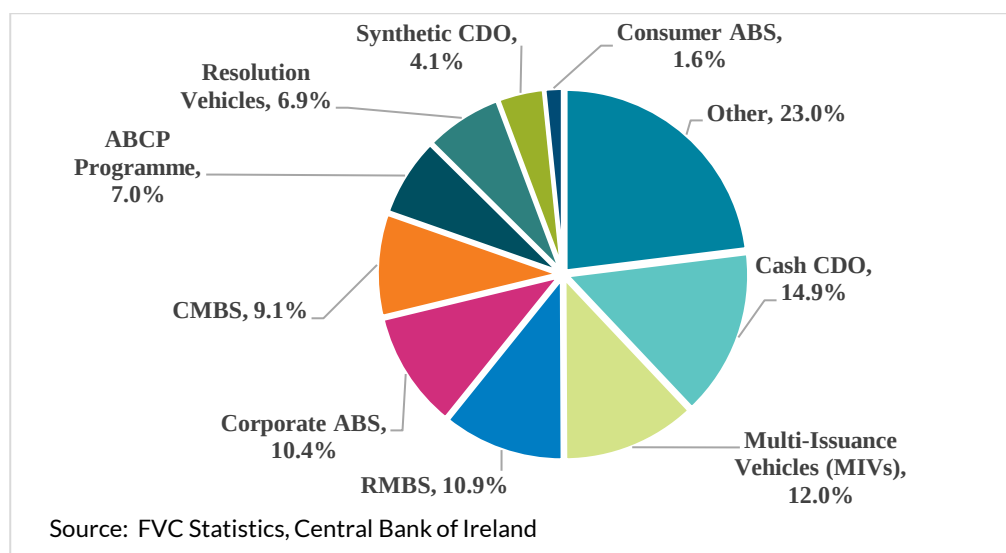
A recovery in securitisation became evident from early 2013, with the number of vehicles rising steadily from 675 in Q1 2013 to over 1,049 in Q2 2018 (Chart 2). This reflected the emergence of a new trend in securitisation, that of non-banks sponsoring relatively smaller SPEs engaging in a more diversified pool of securitised assets. However, overall AUM has not recovered to pre-crisis levels, mainly because of the winding up of mortgage based securitisation and resolution SPEs, as shown by significant dips in AUM in 2016 and 2017. Exchange rates cause additional volatility in AUM due to the large number of US and UK sponsors. Assets held by these entities in sterling and US dollars are converted into euro for reporting purposes.

¹³ Prior to the availability of granular data in 2009, the Central Bank monitored the securitisation activity of Irish-resident banks and also observed certain securitisation activity among other financial institutions.

¹⁴ Please see section 6.1 for more details on retained securitisation, including a basic model.

Chart 2: Securitisation SPE AUM and number of vehicles

The latest snapshot of securitisation types shows how diverse the sector has become (Chart 3). Residential and commercial mortgage backed securitisation and resolution SPEs account for just 27 per cent of all securitisation entities, from a dominant position in the years before 2011. The emergence of new securitisation activity is not confined to a particular category and, in fact, the “other” category has expanded strongly. There are few limits as to the nature of securitisation in the “other” category, which can include cash flows such as nursing home receipts, royalty payments, or life settlements, etc.

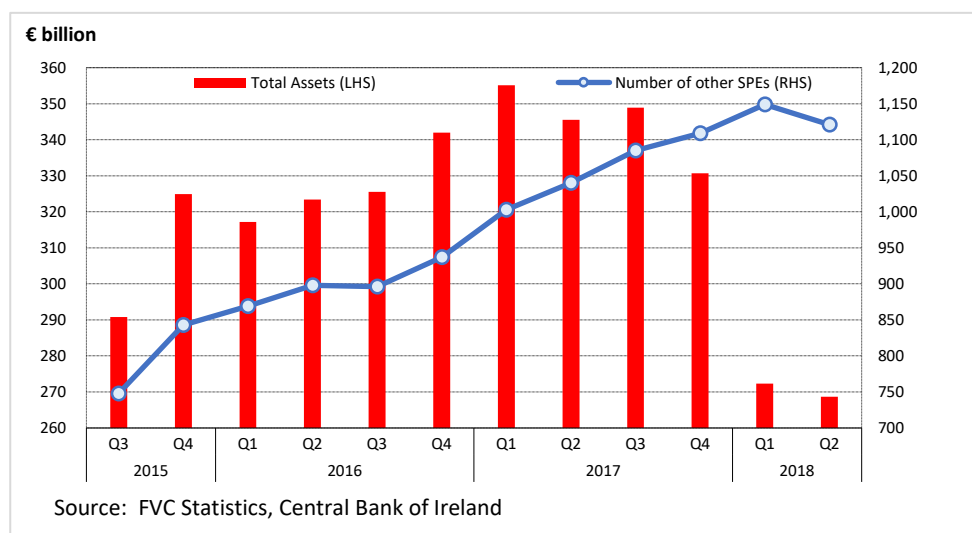
Chart 3: Securitisation SPE activity by AUM, Q2 2018

4.2 Overview of Other SPEs

For other SPEs, the data set is considerably shorter (Chart 4), as reporting commenced in Q3 2015. However the trend of a rapidly increasing population of vehicles is also apparent, with numbers rising from 750 in Q3 2015 to 1,150 by Q2 2018, representing even stronger growth in numbers than securitisation SPEs. The dip in AUM in Q1 2018 is caused by a technical reclassification of a small number of vehicles rescinding their S110 designation and thus falling outside the reporting

population. In general, the sector is unevenly distributed between SPEs with some very large SPEs and many small SPEs, meaning that a small number of SPEs have an outsized impact on the AUM of the overall population. In addition, a number of vehicles changed their business model from other SPEs to securitisation SPEs in Q2 2018, causing a significant jump in the number of securitisation vehicles at the expense of other SPEs.

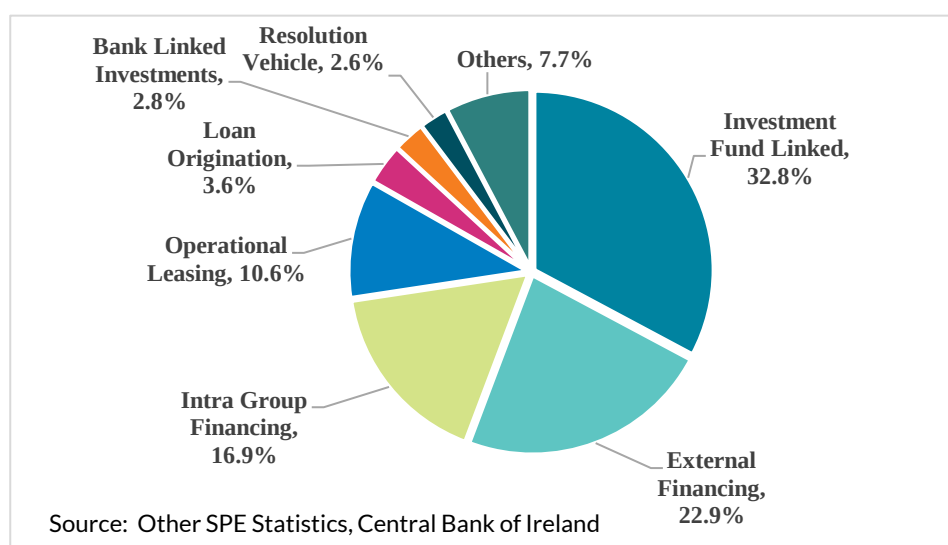
Chart 4: Other SPE activity by AUM



Other SPEs can be split into 14 different categories of activity (Chart 5). The four biggest activities represent over 83 per cent of the sector, namely intergroup financing, external financing, fund-linked investment and operational leasing. Fund-linked investment has shown the strongest growth over recent quarters, whereby investment funds undertake some or all of their portfolio investment through an SPE, for tax reasons as explained below. Loan origination activity declined markedly in the population from Q1 2018 due to a technical S110 classification issue, rather than an economic development. Golden and Maqui (2018) provides more detail on risks and financial flows within the sector.

Other SPEs split into 14 different categories though with significant levels of concentration

Chart 5: Other SPEs activity by AUM



5. Sponsors

Sponsoring entities are diverse, covering over 60 combinations of country and sector, though some distinct patterns are apparent across securitisation and other SPEs.

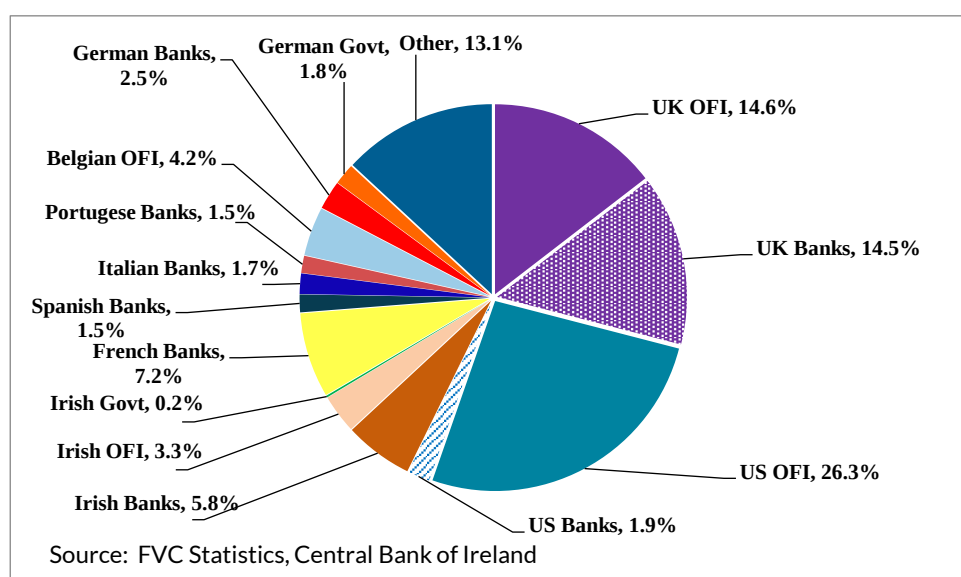
The sponsor entity sector can also have an impact on whether the SPE is consolidated, with regulated entities such as banks more likely to consolidate vehicles into their financial accounts.

For securitisation SPEs, sponsors tend to be EU and US banks and other financial institutions, with a particular bias towards the US and UK (Chart 6):

- Irish sponsors are generally domestically-focused banks issuing debt based on residential mortgages. As such, domestically-sponsored activity mostly reflects traditional securitisation initiated by banks and based on large mortgage pools;
- US sponsors are mostly financial auxiliaries, i.e. a range of investment entities including asset and capital managers, advisors and servicers, issuing debt securities based on Cash CDOs and commercial mortgages;
- UK sponsors split almost evenly between banks and non-banks though both engage in relatively diverse activity, namely issuance based on ABCP, Cash CDO and Corporate ABS. Multi-vehicle structures are also significant;
- German sponsors, both bank and non-bank, engage almost exclusively in debt issuance based on receivables;
- French sponsors are predominantly banks engaging in a diverse range of debt issuances not based on mortgages;
- Belgian sponsors, both bank and non-bank, are mostly linked to multi-vehicle structures.

Sponsoring entities are diverse, covering over 60 combinations of country and sector

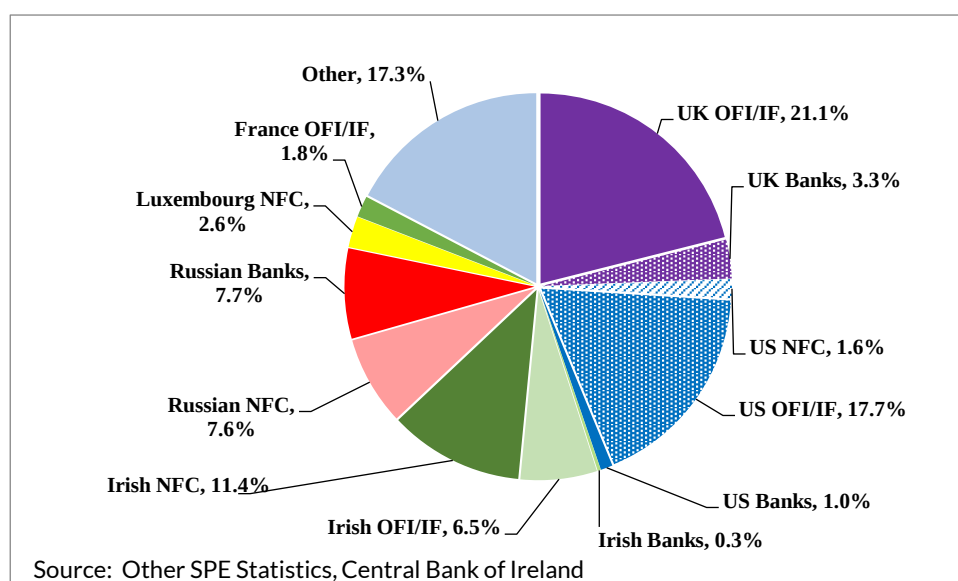
Chart 6: Country and Sector of Securitisation SPE sponsors



For Other SPEs, Non-Financial Corporations (NFCs) are also prominent sponsors in addition to banks and various non-bank financial entities (Chart 7).

- Irish sponsors are mostly multi-national NFCs, including some companies that re-domiciled their headquarters to Ireland, that are engaged in intra-group financing, external financing and operational leasing activity. Fund-linked investments linked to Irish-resident investment funds are also significant.
- UK sponsors are mostly fund managers employing SPEs to undertake investments on behalf of investment funds.
- US sponsors engage in a wide variety of activities, with various investment entities sponsoring intra-group financing activity the most prominent. Apart from motivations already mentioned, tax disincentives for US sponsors to repatriate foreign earnings onshore may also have played a role up to recently.
- Russian sponsors are evenly split between banks and NFCs and engage almost exclusively in external financing activity.

Chart 7: Country and Sector of Other SPE sponsors



The tax regime is important in choosing a location to establish an SPE. In Ireland's case, this means the interaction of particular provisions of the domestic tax regime with those of 73 other countries through double taxation treaties. Two particular provisions of Ireland's tax regime for SPEs ensure that taxable gains within the SPE are very close to zero:

- Realised and unrealised profits can be included as tax-deductible interest payments on profit participating notes/loans, or within derivatives known as total return swaps, in certain instances;
- Withholding taxes are not applied to interest or swap payments on Eurobonds, commercial paper or trades unconnected in Ireland with respect to payments to residents in any EU or treaty partner country.

The tax regime is important in choosing a location to establish an SPE

Profits, when distributed by the SPE, should be subject to tax at the investor level in their countries of residence. SPEs generally make very small but non-zero tax payments, however, which can discharge tax liabilities elsewhere. This occurs through two channels:

- Bilateral tax treaties with 73 other countries;
- Tax provisions in the other countries.

In addition, rules governing transactions between Irish resident entities allow for tax-free profit extraction in certain instances.

For example, an Irish-resident SPE can pass the entire profits from a portfolio of assets to an Irish-resident investment fund, leaving only residual amounts of taxable income. The investment fund pays no Irish tax on either income gains or increases in net asset value, with tax instead being due at the investor level.¹⁵ Since these profits were accrued by a company, rather than a fund, the structure of the tax system in another country and the relevant tax treaty can ensure that the fund investors have discharged their tax liability on these investment gains.

Another example is where the provisions of a corporate tax system in another country specifically allows for tax to be paid by the debtor company in a transaction between two companies. If the debtor company is an Irish-resident SPE, the tax liability can be discharged in Ireland under the relevant double taxation treaty.

We provide a typical tax-driven business model in the next section.

Taxation is unlikely to be the only factor behind this cross-border dimension, however. The economic literature suggests that various aspects of the legal and regulatory framework in the sponsor country can encourage capital to flow to other countries (for example, Avdjiev et al (2016), Bengui et al (2014) and Cizel et al (2016)). Herding behaviour can also be important, namely how sponsors from the same country tend to replicate the activity of their peers (IMF, 2000). Future Central Bank research in this area aims to shed more light on country-level factors driving cross-border debt issuance through Irish-resident SPEs.

Taxation is unlikely to be the only factor behind this cross-border dimension, however

6. Business models

The five business models below outline typical activities undertaken by Irish-resident SPEs and possible underlying motivations therein. While these models do not cover the whole range of activities, they do cover most assets within the sector when subject to some variations. The first three examples of business models are typically employed by bank sponsored SPEs, and the final two are SPEs sponsored by Funds.¹⁶

¹⁵ This is provided for under the gross-roll-up regime as explained in Office of the Revenue Commissioners (2018a) “*Investment Undertakings Part 27-01A-02*”.

¹⁶ Golden and Maqui (2018) provides another layer to potential motivations for banks, analysing the balance sheet characteristics of international banks employing Irish-resident SPEs.

6.1 Securitisation model

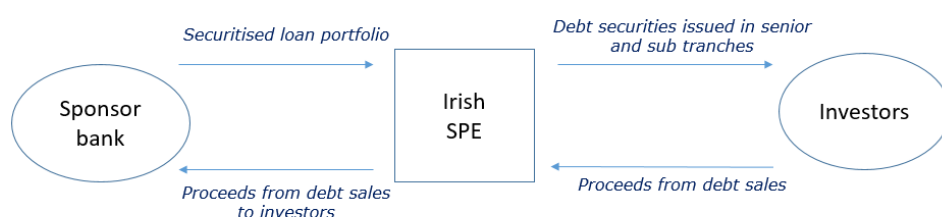
The first model, the standard securitisation model, is relatively straightforward and is also the model most commonly employed (Figure 1).

In this model, a bank passes debt, such as mortgages, to the Irish-resident SPE which issues debt securities to investors based on the cash flows behind this debt.

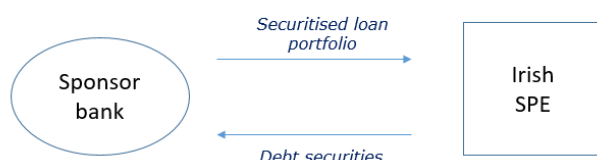
These debt securities are usually tailored to investors and are often issued in senior and subordinate tranches. The proceeds of these debt sales are passed to the bank via the SPE. Motivations for the bank include receiving the proceeds of these debt issuances, reducing loan portfolios and earning servicing fee income.

A variation on this model, retained securitisation, features banks or firms purchasing back the newly securitised debt instruments, which originated on the bank's balance sheet. It was prevalent during the financial crisis as banks sought to transform existing assets into eligible collateral to access central bank liquidity. This motivation is much less prevalent today though some banks and firms engage in retained securitisation, for example, to retain certain tranches of risk while selling others to investors.

Figure 1: Standard securitisation model



Special case: Retained securitisation



6.2 Split returns model

This model is employed in various ways by both securitisation and non-securitisation vehicles sponsored by banks. The Irish SPE holds a portfolio of investment assets, such as debt securities, and the returns are split between the bank and the SPE's debt.

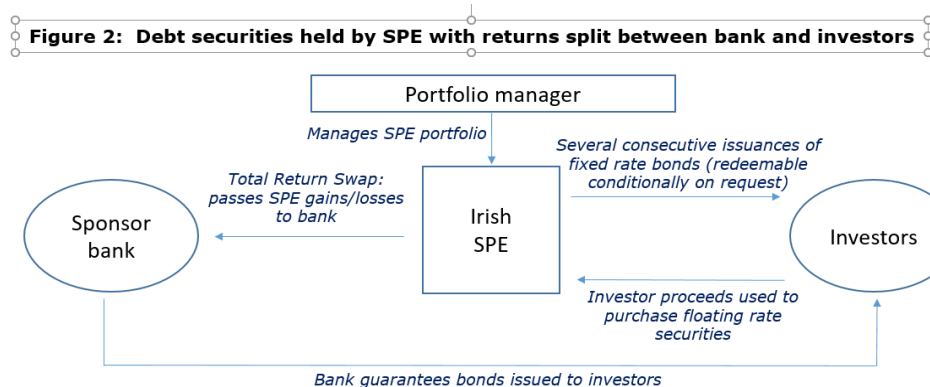
In this particular example (Figure 2), the Irish SPE issues bonds with a fixed rate of interest to investors that are redeemable on request. The SPE then uses the proceeds to purchase a portfolio of high quality, long-term, floating rate government bonds. Management of the portfolio is delegated to a third party. A derivative instrument, called a total return swap, is used to pass gains or losses, realised and unrealised, from the SPE to the bank once investors are paid.

In this way, the bank gains exposure to a portfolio of long-term assets, purchased using cash flows from investors. However, the bank is exposed to margins between the floating and fixed rates on a portfolio built on maturity transformation. Furthermore, the bank guarantees the bonds issued to investors against risk of default within the portfolio. Variations on this theme include the bank passing over part of its portfolio to an SPE.

Motivations for the bank include receiving the proceeds of these debt issuances, reducing loan portfolios and earning service fee income

The bank gains exposure to a portfolio of long-term assets, using cash flows from investors

Motivations may include risk management or access to cash flows. Other motivations may also apply, e.g. more favourable tax or regulatory treatment, particularly where investors or the bank are running consistent losses. International co-operation is critical to understand such structures where the activity straddles national boundaries.



6.3 External financing model

In this model (Figure 3), the bank transfers assets to the SPE, which ring-fences the assets as collateral backing debt issued to investors. The assets are governed by Irish property rights in the event of dispute. The SPE is set up as a stand-alone entity outside of the sponsor's group structure, with a charity or other body technically owning the SPE, so that assets are not accessible by the bank. This ownership is technical, with contracts structured so that investors have priority over the assets of the SPE. The bank also guarantees assets in the Irish SPE.

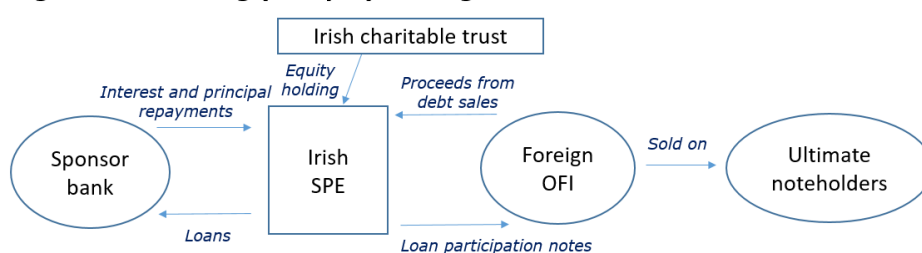
Loan participation notes are then issued to an intermediary and on to investors with flows returning to the bank via the SPE. The intermediary is usually quoted on a stock exchange, often the Irish stock exchange. Such listings require that the prospectus describing the debt issuance, including risk factors, is approved by the home country regulator.

The bank achieves cheaper funding or access to funding markets by guaranteeing the assets if they are under stress, whilst ring-fencing the assets if the bank is under stress.

This business model describes SPEs sponsors in various countries and the predominant activity of Russian sponsored SPEs. The business rationale is relatively transparent.

The bank achieves cheaper funding or access to funding markets, by providing these reassurances to investors

Figure 3: Accessing (cheaper) funding



6.4 Tax-driven fund investment model

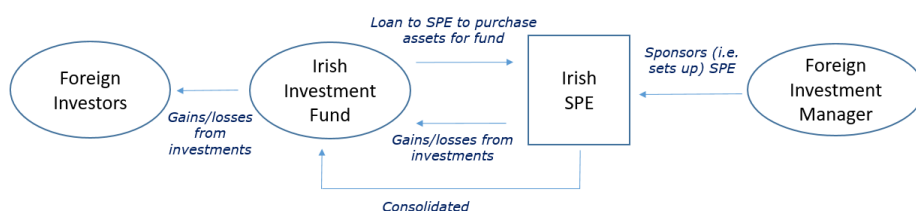
This model shows an SPE employed with tax efficiency as the key motivation (Figure 4).

The sponsor of the Irish SPE is a foreign investment manager of an Irish-resident investment fund whose shares/units are owned by foreign investors. The Irish SPE receives a profit participating loan from the fund and uses the proceeds to purchase securities from the fund. In return, the fund receives interest dependent on the performance of the SPE's assets. The Irish SPE is wholly owned by the fund and consolidated into its accounts.

These structures are designed for tax efficiency purposes. The Irish SPE holds foreign debt securities and, as a company rather than a fund, discharges a tax liability for investors in certain countries, on receipt of profits from the fund, provided for by that country's tax system and the relevant country's double taxation treaties with Ireland. Furthermore, any inflows of income or gains derived from these investments benefits from no withholding tax in Ireland. There are only residual taxable profits left in the SPE as any income or gains in the SPE, realised and unrealised, can be matched by a tax deductible interest payment to the fund, a method known as profit extraction.

An SPE employed with tax efficiency as the key motivation

Figure 4: Tax-driven fund portfolio investment



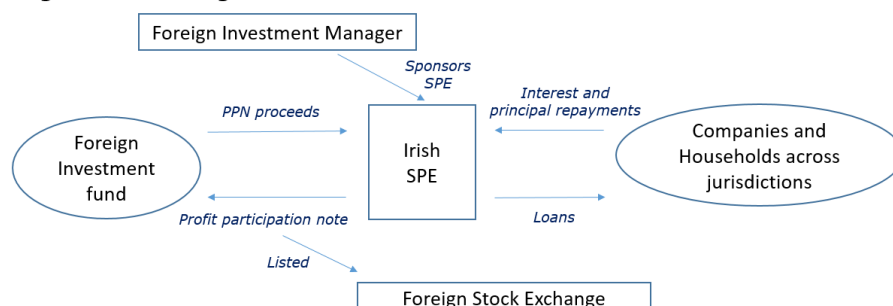
6.5 Loan origination model

This business model also sees the Irish SPE sponsored by a foreign investment manager (Figure 5). In this specific instance, the Irish SPE funds itself through the issuance of a profit participating note to a foreign investment fund. The Irish-resident SPE then uses the proceeds to make loans to households and companies across countries. This is often done through an intermediary that provides the loans, using funds provided by the SPE, and passes these to the SPE. But it can and is also done by the SPE itself, as in this case. The profit participation note is listed on a foreign stock exchange.

This SPE engages in peer-to-peer lending, i.e. acting as a platform to connect borrowers with a lender, which is not generally regulated. Nevertheless, there is potential for a regulatory 'vacuum' in which loan issuance can take place without the knowledge or supervision of any authorities. There may also be some tax neutrality incentives.

There is potential for a regulatory 'vacuum' in which loan issuance can take place without the knowledge or supervision of any authorities

Figure 5: Loan origination



7. SPEs and the Irish Economy

The SPE industry paid €273 million in fees and commissions to Irish entities in 2017, which is a good proxy for value added to the Irish economy.¹⁷ In terms of taxes paid, the Revenue Commissioners published an estimate of €128 million from Section 110 entities (Office of the Revenue Commissioners, 2018).¹⁸ Though not small in absolute terms, these figures are small percentages of the SPE asset base. Employment levels are also very low given SPEs are essentially pass-through entities. Within the balance of payments, the net impact is also limited as flows to and from SPEs are mostly vis-à-vis foreign entities.

Most securitisation activity undertaken by Irish sponsors has been traditionally underpinned by mortgage loans. Before the financial crisis, this facilitated further bank lending by allowing banks to remove some risks from their balance sheets but also fuel the property boom. During the crisis, Irish banks employed retained securitisation extensively, so as to turn their assets into debt securities that could be accepted as collateral to access ECB liquidity facilities. Meanwhile, new mortgage backed securitisation did not take place as this market remained frozen worldwide. The recovery in securitisation by domestic entities was subdued in recent years and remains almost exclusively mortgage-based, in contrast to most securitisation activity sponsored by foreign entities.

Securitisation activity more recently has had two key effects on the Irish economy. Loans owed by Irish residents and held in securitisation SPEs total €57 billion in nominal terms (Table 3). While this is the contracted amount of debt, their market value is just €43 billion.¹⁹ The first effect can be seen in loans securitised by Irish bank sponsored SPEs, which are mostly performing mortgages. To quantify the significance of this support, 25 per cent of the €101 billion stock of loans to Irish residents for house purchase in Q2 2018 are securitised. However, the incentives that securitisation provide for bank lending seem to be currently concentrated on the lowest end of the lending risk spectrum. Were securitisation market conditions to deteriorate sharply and loans return to bank balance sheets, the return of relatively low risk loans may partially mitigate the negative impact on further bank lending. The second effect reflects the purchase of non-performing residential mortgages by foreign banks and, mostly, non-banks, i.e. asset managers and loans servicers. For the Irish economy, the benefits relate mainly to supporting a market for banks to sell these loans and thus improve their balance sheets.

The SPE industry paid €273 million in fees and commissions to Irish entities in 2017

The incentives that securitisation provide for bank lending are currently concentrated on the lowest end of the lending risk spectrum

¹⁷ Such estimates have in the past been significantly revised so this figure should be viewed as a provisional estimate.

¹⁸ This estimate would exclude any securitisation SPEs in our population not availing of Section 110 tax provisions though we have not seen evidence that this is a significant sub-sample. Similarly, the estimate also excludes Other SPEs not availing of Section 110 tax provisions which industry sources suggests was not a large sample in 2017.

¹⁹ SPEs do not tend to mark their securitised loans to market on a quarterly basis, not least because market pricing is not available. So market value for securitised loans is a mix of mark-to-market and book values.

Table 3 | Irish debtor securitised loans by sponsor (excl. NAMA), in € billion, Q2 2018

Sponsor	Nominal value	Market value	Mortgage backed debt at market value
Total	57.4	42.7	37.0
Irish banks	26.7	25.0	25.0
Foreign banks	3.8	1.7	0.9
Irish non-banks	3.3	3.1	2.4
Foreign non-banks	23.6	13.0	9.2

Source: FVC Statistics, Central Bank of Ireland

Other SPEs do not appear to have a significant direct impact on the Irish economy, despite very large volumes of transactions flows. Nevertheless, more indirectly, establishing an Irish-resident SPE might be a factor in a decision of an investment fund or an aircraft leasing company to locate in Ireland (Mason, Hayes and Curran, 2010 and Dillon Eustace, 2011).

The largest links between Irish-resident entities are between SPEs and investment funds. Investors in the units/shares of these investment funds are predominantly foreign, which means that money flows to the Irish-resident fund from abroad, flows to and from the Irish-resident SPE and, ultimately, flows back to the fund investors. These links, through consolidation or noted interest, accounted for total assets of €53 billion in Q2 2018, of which €41 billion were sponsored by UK asset managers and similar entities. The other main links, excluding NAMA, are SPEs sponsored by Irish NFCs, amounting to €31 billion in total assets. Within this, €16 billion lie in SPEs engaged in intra-group financing and €7 billion in external financing. These sponsors are mostly multi-national firms headquartered in Ireland. An additional €6 billion of assets are in SPEs engaged in operational leasing activity, whose Irish sponsors are aircraft leasing companies.

8. Conclusion

This Economic Letter seeks to shed light on the Irish-resident SPE industry for interested members of the public. This is part of a wider initiative by the Central Bank of Ireland to increase transparency in the area. Further research technical papers focused on SPEs are in the pipeline for publication by the Central Bank in the coming months.

The authors and colleagues in the Statistics Division of the Central Bank have also begun an international co-operation initiative to better understand the rationale behind SPE transaction flows. SPEs are often part of complex cross-border structures, where the portion of the structure that we see provides limited information. In these cases, we need a communication channel to the sponsor, the entity responsible for the decision to set up the SPE. These sponsors, where they are financial entities, are regulated in their home jurisdictions. Therefore, we plan

Other SPEs do not appear to have a significant direct impact on the Irish economy

We plan to initiate research with our counterparts in other jurisdictions to more fully understand their underlying business rationale

to initiate research with our counterparts in other jurisdictions on these SPE structures to more fully understand their underlying business rationale.

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