WHY NOT SECURITISE?

SECURITISATION IS AN INVALUABLE WAY FOR COMPANIES LOOKING TO LIGHTEN THEIR BALANCE SHEETS. BUT WHAT IS SECURITISATION AND HOW DOES IT ALL WORK? **TOM ROSS** OF BFINANCE FINDS OUT.

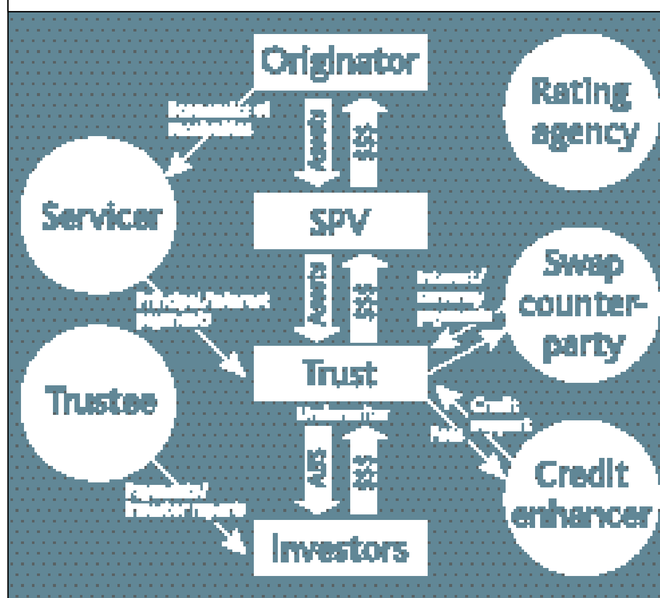
As defined by the European Securitisation Forum, securitisation is a transaction in which "assets are pooled together, with their cashflows or economic values redirected to support payments on related securities" (termed 'asset-backed securities'), issued to investors in the public and private markets. The list of assets that may be securitised has grown as the corporate sector takes greater interest in the technique, but the fundamentals are common to most transactions. The most important issue is the legal separation of the assets – via a 'true sale' – from the ultimate beneficiary of the transaction, the 'originator'. This ensures that payments are derived exclusively from the performance of a segregated pool of assets and removes the investor from any insolvency or bankruptcy risk on the part of the originator.

WHY SECURITISE? Securitisation provides an opportunity to raise cheap finance by turning illiquid and often undervalued assets into tradable capital market instruments. A securitisation will typically result in a lower cost source of financing than bank and capital markets routes because the debt securities issued under the deal will carry a higher rating (and therefore a lower interest rate) than the long-term credit rating of the originator. In addition, securitisation enables the issuer to remove illiquid assets from its balance sheet (to the benefit of various financial ratios) and utilise capital more efficiently. By transferring asset risk to bondholders at a price close to that raised by a third-party disposal, a firm may reduce balance sheet leverage and release cash to boost its business strategy.

WHO DOES IT? Securitisation is common among financial institutions which routinely repackage revenue-generating assets from their continuous business activities (such as home loans, credit cards). Property companies with similar assets have been quick to take advantage of the opportunity to lighten their balance sheet and access cheaper funding offered by securitisation. More recently, firms ranging from telecoms groups, utilities, football clubs and motorway service station operators have issued debt-backed by revenues generated from fixed assets that are under-priced in traditional equity market valuations. Although not exclusively, firms with strong tangible assets backed by a well-documented track record and mature demand are considered natural obvious candidates for securitisation.

TRANSACTION STRUCTURE. There are many ways to structure a securitisation and arrangers typically recognise the need to alter their deal templates to fit the needs of their client. Nevertheless, some basic principles are common and *Figure 1* demonstrates the fundamental flows involved in a classic securitisation. At the simplest level, the originator transfers the chosen pool of assets to a 'bankruptcy-remote' special purpose vehicle (SPV), which then issues debt stock to investors. In some cases, the SPV conveys the assets to a trust, the beneficiaries if which are investors.

FIGURE 1
TRANSACTION PARTICIPANTS AND FUNCTIONS – CREATION OF AN ABS SECURITY.



The interest and principal paid to the investors is serviced by the assets transferred to the SPV, which transfers the proceeds of the debt issuance back to the originating corporate. The servicing function (managing revenues generated by the asset and passing the benefit to investors) may be carried out by the originator in accordance with its existing credit and collection procedures.

The transfer of assets can be effected in a number of ways, each with different implications for the rights of bondholders, but the transaction must represent a 'true sale' of assets (the transfer of substantially all the risks associated with ownership of the assets), not just a secured financing. Well-established transfer mechanisms include novation, assignment, sub-participation and declaration of trust. Under

a whole business securitisation (see below), it is more likely that assets are ringfenced to be used as security for a loan from bondholders rather than legally transferred.

CREDIT ENHANCEMENT. In many cases, issuers of asset-back securities use credit enhancement techniques to guarantee the desired credit risk profile for the securities issued (higher than the originator's unsecured debt). This may be achieved through internal techniques such as subordination (in which subordinated tranches of the issue absorb losses resulting from default or underperformance relating to the underlying asset) or external methods, such as surety bonds, third-party guarantees or letters of credit.

These external methods expose the investor to third-party risk (a downgrading of the issuing institution may have a knock-on effect on the securitisation), but a cash collateral account (borrowed from a commercial bank and invested in short-term paper) does not.

WHOLE BUSINESS SECURITISATION. As stated above, there is no fixed route for securitisation. For example, the UK is unique in that whole business securitisations are possible. Examples include RHM, The Really Useful Group and Welsh Water. With a whole business securitisation, the securitised assets remain the property of the operating company, and bondholders are offered a charge over the assets. As these assets will require active management to be able to continue paying down the debt, the repayments will depend on management performance.

However, the assets are isolated from the insolvency of the operating company as investors are granted the power to appoint a third party, whose sole duty it is to manage the assets for the benefit of the creditors.

'ONLY LARGE DEALS BY ISSUERS SEEKING A WIDE INVESTOR BASE AND A LIQUID SECONDARY MARKET WILL ISSUE ON THE PUBLIC MARKET'

UNDERWRITERS. As with any securities issue, the role of the underwriter is to ensure that the deal attracts the type and volume of investors desired by the issuer, at a price the latter is comfortable with. As such the underwriter of a securitisation should provide guidance on deal structure. In most cases, securitisations are issued in a number of tranches with varying credit, payment, coupon and maturity characteristics to attract the desired range of investors. The underwriter will also advise on whether to issue the securities publicly or privately.

Generally, only large deals by issuers seeking a wide investor base and a liquid secondary market will issue on the public market because of the high cost of securities registration, listing, reporting, legal, accounting and other expenses. Private issues are common, and even tranches of public offerings may be issued privately in order to focus marketing efforts on a more limited number of institutional investors with specific requirements.

LEGAL/TAX RESTRICTIONS. Legal, tax and regulatory constraints on securitisation in the UK are light compared with most European jurisdictions. As a common law jurisdiction, different securitisation structures have been able to evolve relatively free of legal restrictions, unless expressly prohibited by existing statutes. Nevertheless, it is important to identify any legal or regulatory issues restricting the transfer of assets by the originator and to ensure that issuing vehicle is rendered 'bankruptcy remote' from the obligator's creditors. The situation varies widely across Europe as does the taxation of the income of SPVs.

CREDIT RATINGS. The ratings process starts with a feasibility study which evaluates the prospective issuer's ability to securitise its assets according to criteria including management, history, strategy and sustainability of market position.

An agency's ratings committee will also review the deal's financial structure (to determine the levels of credit enhancement required), the historic performance and credit quality of the underlying receivables (including assessment of potential collateral losses under given scenarios) and any relevant legal issues (for example, rights of creditors/bondholders and status of bankruptcy law – whole business securitisations, for instance, are considered by some to be under threat from planned UK government reforms). The strengths and weaknesses of the origination process and underwriting practices will also be discussed, while the servicer will need to provide evidence of robust collection and servicing methods.

INVESTOR RELATIONS. As well as their superior yield over investment-grade bonds, asset-backed transactions are attractive to investors seeking alternative spread-based investments and risk diversification due to their low correlation with the equity markets. Debt market investors also favour the stable long-term cashflows that mature fixed assets offer. The variety and flexibility of credit, maturity and payment structures and terms made possible through securitisation means that very specific investor requirements can be met.

Issuers typically provide investors with regular post-deal information on the performance of the individual tranches of each individual securitisation, as well as that of the underlying assets. The data is usually prepared by the servicing agent and reported by the trustee or payment agent on behalf of the issuer. Most types of asset-backed securities pay back principal as well as interest on a monthly basis and this information helps the investor make an accurate assessment of the securities' yield.

DRAWBACKS. Many firms have found the securitisation process highly consumptive of time and internal resources. The accurate statistical analysis of previous cashflow performance required in securitisations often stretches the issuer's existing IT capabilities. The continuing post-issuance reporting requirements may also demand additional IT investment.

In addition, should bondholders insist on clear separation of asset origination and maintenance, the issuer may need to negotiate service level agreements with an external servicing agent. The argument that the resultant processes may provide the issuer with a greater understanding and analysis of its own assets and business cannot hide the size of the task.

Add this to the board room attitude that equates securitisation with selling the family silver and it is clear that would-be issuers face philosophical, as well as practical, hurdles. But with the investor demand underlining the bond market's appetite for fixed assets that generate mature, stable cashflows, the need to lighten the balance sheet is forcing many companies to take up the challenge.

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