SECURITISATION IS BACK

THIS USEFUL FINANCIAL TOOL CAN REDUCE COMPANIES' BORROWING COSTS AND DIVERSIFY THEIR FUNDING SOURCES. ROBERT PLEHN EXPLAINS HOW

Often associated with the 2008/9 meltdown of the global financial markets, securitisation has had a tarnished reputation. But this is an oversimplification. Like any other financial tool, securitisation itself should not be held accountable for the meltdown – it was the application and use, or misuse, of the tool that was problematic.

Today, securitisation continues to re-establish itself, providing some serious food for thought to corporate treasurers who want to diversify their funding mix. So, what are the benefits of securitisation and which are the key points to consider?

Overview

In its simplest form, securitisation allows entities to borrow money from (and, in some cases, transfer risk to) the capital markets. The process essentially involves the creation of tradable securities that are backed by a pool of ring-fenced, cash flow-generating assets. These cash flows are 'tranched' so that different levels of risks and tenors of debt can be sold to investors.

The tranches are typically rated by the rating agencies, so that investors can have an easily recognisable guide to the risk they are taking on. That said, given rating agency mistakes, particularly in the US sub-prime mortgage market, most investors will now do their own in-depth risk analysis. As such, the rating agencies are used as a second pair of eyes, or, in some instances, they are required by the terms of investors' (particularly asset managers') investment mandates.

Getting practical

For larger corporates, securitisation is a direct funding tool whereby the company can obtain funding by issuing bonds backed by its existing assets and cash flows. This is achieved by selling the relevant assets into a special purpose bond issuing-vehicle (SPV), which is usually consolidated onto the corporate's balance sheet.

Examples of assets or cash flows that can be securitised include: shorter dated trade receivables and longer dated cash flows arising from commercial property holdings using a sale and leaseback structure. For instance, Lloyds recently assisted Unite Group in its recent issuance of £380m of secured bonds backed by the cash flows arising from its student accommodation rental business. The transaction allowed Unite to raise 10-year funding at an attractive fixed rate funding cost of 3.374% (equating to gilts + 150 bps per annum at the time of pricing).

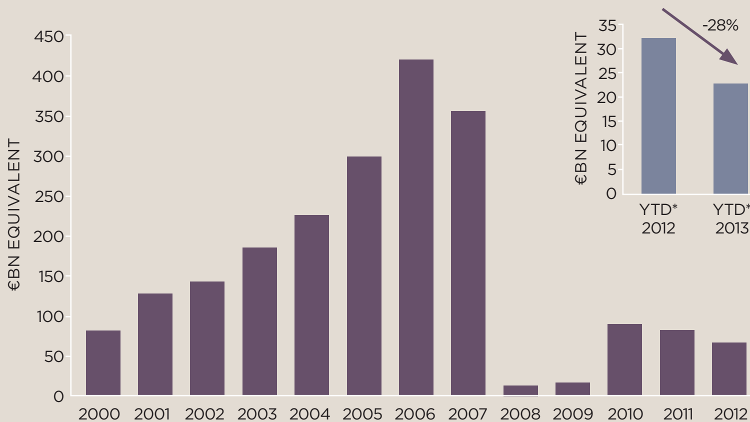
In the UK and certain other jurisdictions, it is also possible to undertake 'whole business securitisations'. In these transactions, a corporate can raise funding not only on its existing receivables, but also on its future receivables, applying a legal structure that uses fixed and floating charges to ring-fence assets and give operational control of the business to bondholders (through an administrator) in the event of a corporate insolvency. These transactions generally work best for businesses operating in markets with high barriers to entry, which hold a significant share of their respective markets and which generate robust and sustainable cash flows.

For smaller corporates that may not have the critical mass of asset pools to securitise, the securitisation market is still relevant as their bank funders may be using it to fund themselves (typically by packaging up cash flows associated with mortgages, credit cards, auto loans, SME loans, etc). A smaller corporate may therefore find that its own loan from its bank may be in a securitisation pool. In a well-functioning and healthy securitisation market this should mean that banks can obtain wholesale funding at a more attractive price, in turn leading to a lower cost of credit for their customers.

Market and regulatory backdrop

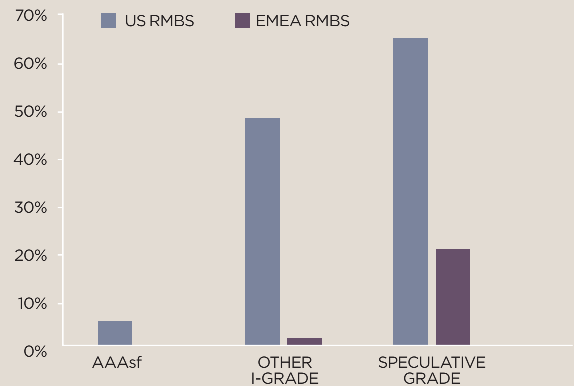
Until 2008, Europe and the UK had a growing and healthy securitisation market, albeit one that was much smaller than the US market, and one

TOTAL EUROPEAN ISSUANCE OF PUBLICLY PLACED ASSET-BACKED SECURITISATIONS



*YEAR TO DATE UP TO END OF MAY (SETTLEMENT DATE). SOURCE: LLOYDS/DEALOGIC

EUROPEAN VS US RESIDENTIAL MORTGAGE-BACKED SECURITISATION TOTAL LOSSES



BASED ON 2001-2011 PRIMARY ISSUANCE. SOURCE: FITCH RATING AGENCY, 13/11/12

that was too dependent on a more concentrated, and, in some cases, highly leveraged, investor base. While global securitisation markets, with a few exceptions, essentially shut in 2008 and 2009, European securitisation bonds (ie bonds backed by assets originated in Europe) enjoyed quite good credit performance.

Nevertheless, there were issues, and credit losses, in Europe. Many of these arose from European investors – mainly banks and insurance companies – purchasing significant amounts of exported US residential mortgage-backed bonds that failed to perform due to poor mortgage underwriting standards. Many investors also experienced material accounting mark-to-market losses (but not credit losses) due to a significant and rapid sell-off of securitisation bonds by liquidity-starved, leveraged investors.

Unfortunately, at the time, markets, regulators and politicians ignored the distinction between 'good' and 'bad' securitisations (ie looking at the quality of underwritten assets and the level of issuer 'skin in the game' to distinguish deal types). As a result, all securitisations were unfairly tarred with having been a primary cause of the financial crisis. This meant that many European politicians and regulators were determined to, at best, regulate the product and, at worst, drive the product from the markets.

Consequently, much of the initial European rhetoric around securitisation was highly critical and many European bodies attempted to regulate issues that arose from the US, yet had less relevance in Europe.

Fast forward to 2013 and the world has changed. Firstly, the market is recovering, albeit slower than many would like. Secondly, European regulators and, to a lesser but increasing extent, politicians have not only accepted the differences in performance between 'good' and 'bad' securitisations, but also realised that, if used correctly, the product can serve an important role, linking capital market investors to the real economy. Finally, as Europe strives for growth, politicians have recognised that securitisation can be a useful tool for institutions to raise funding as the economy begins to recover.

A far brighter picture

So where is the market now? In line with the general tightening of wholesale funding spreads, the costs associated with issuing securitisations have reduced dramatically in the past 18 months, making it a much more attractive funding alternative for corporate treasurers. This is partly due to a rehabilitation of the instrument, but also due to the impact of central bank actions (quantitative easing and massive injections of liquidity into the markets), leading to a supply and demand imbalance for the product.

More and more investors are seeking to invest in securitisation in their search for yield. Financial institution issuance has simultaneously reduced, however, as these entities deleverage (leading to lower funding needs) and avoid wholesale funding markets because they are able to access cheaper central bank funding. Hence an imbalance is created.

That said, despite the good news of spread tightening, the European securitisation investor base is still too thin. Much work needs to be undertaken by the market (issuers, arrangers and investors) and regulators and politicians to continue with the product's rehabilitation and deepening of the investor base. A stable and well-functioning securitisation market will benefit corporate treasurers directly by allowing them to issue into these markets on a more regular basis and at tighter spreads. Indirectly, it will also lower their bank funding costs, as banks can access this market in a similar manner.

Seize the opportunity

In the near term, securitisation market conditions are ripe for issuance, given the supply and demand imbalance referred to above. Corporates that have recently taken advantage of this include communications infrastructure provider Arqiva and shopping centre owner Intu Properties, as well as Unite.

For this technical pricing benefit to remain for the longer term, however, it is important that the securitisation market continues to re-establish itself. Corporate treasurers can play an important role here by understanding that misapplied regulation to this product will lead to increased funding costs for them and by assisting the industry in its continuing efforts to educate regulators and politicians as to the benefits of securitisation when used appropriately.

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