FOOD FOR THOUGHT

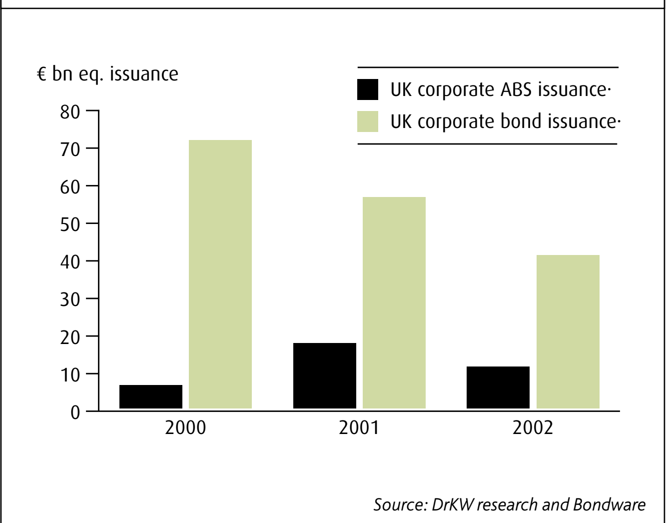
IN AN ECONOMIC CLIMATE WHERE FUNDING IS INCREASINGLY HARD TO FIND, SECURITISATION HAS COME UP TRUMPS FOR BUSINESSES IN THE UK. **CHARLES HYATT** OF DRKW DELVES DEEPER.

Since it began in 1986, securitisation in the UK has developed rapidly and is now the largest securitisation market in Europe. While in volume terms issuance by financial institutions has represented the bulk of the UK market, companies are increasingly turning to securitisation as a means of financing ever more diverse assets and businesses. As you will see in *Figure 1*, it now accounts for almost a quarter of bond issuance for UK companies.

While securitisation by financial institutions has led the way (see *Box 1*), the technology and expertise developed for those transactions have formed major building blocks for the corporate market.

EVALUATING THE MERITS. Securitisation is a straightforward and effective form of financing. It has been used to finance assets as diverse as trade receivables and intellectual property. When evaluating the merits of securitisation it is important not just to consider the suitability of this approach purely in terms of financial benefit, but also to assess the soft factors, such as impact on operational flexibility, demands on management time and servicing requirements. In addition, there have been recent changes in both the accounting and legal framework relating to securitisation in the UK, both of which could have material impacts (see *Boxes 2 and 3*).

FIGURE 1
COMPARISON OF CORPORATE BOND AND ASSET-BACKED SECURITISATION ISSUANCE.



Source: DrKW research and Bondware

Box 1
Financial institutions: paving the way

Financial institutions led the initial drive towards securitisation in the UK. The four key drivers behind this are: cost; diversification; balance sheet management; and funding strategy.

In the late 1980s, small specialist mortgage lenders in the UK lacked access to cheap funding through the wholesale bond and loan markets.

Looking to alternative sources of funding they became the first European securitisers. The market remained a relatively specialist one until the early 1990s, when financial deregulation in Europe, the growth of balance sheet collateralised loan obligation (CLO) deals and a wider more sophisticated investor base saw securitisation volumes significantly increase. As this market developed, securitisation became more cost-effective for an increasing number of borrowers.

As a funding strategy, financial institutions realised that securitisation also provided a means to diversify their funding to new investors away from the more traditional inter-bank market and to offer a source of longer term financing that was limited recourse in nature.

The demand from financial institutions has evolved into 'wholesale' corporate loan securitisation and 'retail', such as residential mortgages and credit cards.

The sheer volume of residential mortgage-backed transactions in the UK has increased steadily, with issuances from big names such as Abbey National, HBoS and Northern Rock's established programmes constantly vying for largest deal.

Box 2
Convergence to International Accounting Standards (IAS) by 2005

By 2005, all European Union companies listed on a regulated market will need to prepare consolidated accounts in accordance with International Accounting Standards (IAS). For comparative purposes, a 2004 balance sheet and profit and loss account will be needed, which in turn will require a 2003 closing balance sheet. Therefore, the implementation of IAS will need to begin at the end of 2003.

■ **Issues affecting securitisation transactions and special purpose entities.** There are two fundamental questions for European securitisation transactions under International Accounting Standards. Can the originator derecognise securitised assets following a transfer to the special purpose vehicle (SPV)?; and should the originator consolidate the SPV?

■ **When can an originator derecognise?** IAS 39 currently defines the criteria that need to be satisfied to achieve derecognition. In June 2002, a new Exposure Draft of IAS 39 was released outlining proposed amendments to the current standard. The new Exposure Draft introduces the principle of 'continuing involvement', which acts as a test for derecognition. To the extent an originator has no 'continuing involvement' in the transferred assets, then derecognition should be achievable.

■ **Should an originator consolidate the SPV once the assets have been derecognised?** SIC-12 deals with the consolidation of SPVs and states that consolidation may be required if:

- activities of the SPV are conducted on behalf of the originator;
- decision-making powers are retained by the originator or delegated through 'auto-pilot';
- a majority of the benefits of the transaction are retained by the originator; and
- a majority of the residual or ownership risk is retained by the originator.

Clearly, the above makes non-consolidation of SPV in a securitisation almost impossible and SIC-12 is not being revised as part of the new Exposure Draft of IAS 39.

■ **How does the IAS 39 Exposure Draft deal with the issues raised by SIC-12? Is consolidation still required?** The Draft introduces the concept of a 'pass-through' arrangement, where it is argued that the SPV has no access to the risks and rewards of ownership of some of the assets and liabilities and therefore should not recognise those assets and liabilities.

The key to the new pass-through principle is that the SPV has generally passed the contractual rights to its asset cashflows on to the bondholders. The SPV is therefore allowed to derecognise these assets and so, while SIC-12 may still require consolidation, its balance sheet will be minimal.

■ **Future developments.** While the International Accounting Standards Board (IASB) is reviewing comments on the new Exposure Draft, there is no doubt it is making attempts to assist the securitisation market through the revision of IAS 39. But it is hoped the IASB will consider the feedback on the Draft carefully and make efforts to address the issues raised.

In the UK, we are exceptionally fortunate in having a deep and sophisticated sterling capital markets investor base, which opens up considerable opportunities for securitisation. In recent times, investors have particularly welcomed the lack of volatility associated with securitised paper, as strikingly illustrated by the much lower credit rating volatility shown in *Figure 2*.

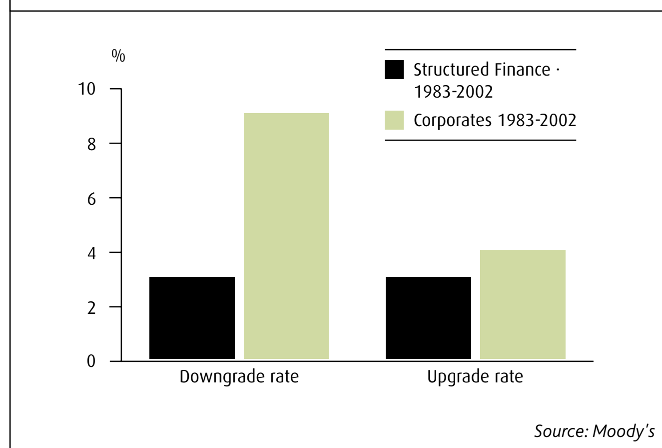
WHOLE BUSINESS SECURITISATION. A key area of securitisation that is becoming of increasing interest to a wide spectrum of companies is whole business securitisation (WBS) – that is, a securitisation raising funds secured on the cashflows generated by the business of an operating company. WBS became an established concept in 1997, following the Welcome Break transaction, which set the trend. Traditionally, businesses with historically stable incomes and predictable future cashflows have been particularly suitable for this type of transaction. Deals that fitted the early mould include RoadChef and Madame Tussauds.

Features that enhance the 'guaranteed' aspect of revenues often relate to characteristics of the business sector. Therefore, highly regulated companies such as Glas Cymru, Anglian and Network Rail are particularly suitable for WBS because of the stability of their cashflows. Established businesses, which require high initial capital investment, are also suitable because of the barrier to market entry for potential competitors. In addition, companies that are 'recession proof' or counter-cyclical, such as the pub sector, may create the required predictability of income streams.

As the areas in which WBS widened, so too did the structures of the deals. For example, pub deals, such as Punch, have used more complex structures, as did the British Telecom deal, Telereal. More recently, further diversification of WBS characteristics can be seen. New sectors include food brands, with the Rank Hovis McDougall deal, and cinemas, with the upcoming Odeon deal shows the diversification in securitised asset classes *Figure 3*. Basel II will also have an important impact on the relative attractiveness of securitisation, which is summarised in *Box 4*.

An outstanding example of how the building blocks developed for securitisation can be used to great effect is in the two Eurotunnel transactions (Fixed-link Finance I and II) completed in 2001 and 2002. These have had the cumulative effect of reducing their debt by more than £700m, as well as achieving other objectives.

FIGURE 2
COMPARISON OF RATING VOLATILITY BETWEEN CORPORATE BONDS AND STRUCTURED FINANCE.



Source: Moody's

Box 3
Update on legal developments in the securitisation market

The most significant legal development of the last year relating to corporate securitisation is the reform of the UK insolvency regime under the Enterprise Act 2002 (the Act). Receiving Royal Assent on 7 November 2002, the Act holds important implications for companies that intend to bring a whole business securitisation (WBS) to market in the years ahead.

The key concept under the current insolvency law is the provision for the holder of a floating charge over the whole (or substantially the whole) of a company's assets to block the appointment of an administrator and appoint its own administrative receiver over the business. Blocking the appointment of an administrator is significant in the WBS context because it allows a floating charge holder (such as a security trustee) to avoid the concomitant moratorium on enforcement of security and continue to manage the business in a manner that generates revenue to repay bondholders.

The provisions of the Act affecting corporate insolvency are expected to come into force by the summer of 2003. The salient feature from the WBS perspective is that the holder of a floating charge will no longer be able to prevent the appointment of an administrator and will be prevented from appointing an administrative receiver, unless one of the Act's exceptions apply.

The above restrictions will not apply to floating charges created before an (at the time of writing) undetermined date (likely to be the date on which the provisions come into force, according to a 2001 press release). More importantly for those considering a future WBS, the restrictions will not apply to contracts that are part of a 'capital market arrangement' if a party incurs indebtedness of at least £50m and such an arrangement involves a grant of security to a trustee for the holders of rated, listed or traded debt instruments.

The capital market exception should not adversely affect the secured loan structure historically utilised in UK WBS. However, the current drafting of the exception remains somewhat unclear in this regard. Moreover, it appears that traditional bridge financing will not fall within the capital market exception. Significantly, the government has indicated that it intends to clarify the capital market exception by way of amendment prior to the provisions coming into force. Regardless of the outcome, it is certain that WBS will continue to be a breeding ground where creative structural innovations are required to maximise the objectives of visionary corporate originators for the future.

THE ROAD AHEAD. In the future, securitisation will continue to evolve to meet the needs of companies in the UK. Demand for securitised issuance has been robust and has demonstrated its resilience in the current turbulent credit environment. Issues raised by Basel II and the new accounting and legal framework are all factors that will play a part in the continued development of the market. Securitisation is no longer a rarely used financing technique but one that is increasingly being adopted in the main stream, and it is likely that this trend will continue.

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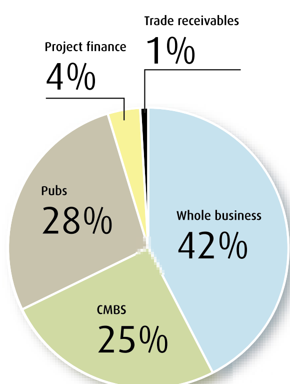
FIGURE 3
DIVERSITY OF CORPORATE SECURITISATION ASSET CLASSES.



Source: DrKW research

Box 4
The impact of Basel II on securitisation

New risk weights (standardised approach)	
Rating	Risk weight
AAA,AA	20%
A	50%
BBB	100%
BB	200%
B or below	250%

The major aim of Basel II Capital Adequacy Accord is to link capital adequacy requirements for banks more directly to risk. The latest proposals provide a number of options financial institutions can use in allocating capital, but in each case the basic principle is the same – banks must allocate more capital and therefore charge more for lower credit quality companies. This is illustrated in the table above.

The strong emphasis on credit ratings is core to the proposals from the Basel committee, effectively crystallising the role of rating agencies as regulators for the industry.

The increased correlation between credit ratings and cost of debt created by Basel II will have direct implications for corporate borrowing costs. The cost of financing for higher-rated companies will fall, while the cost for non-investment grade companies will increase. These changes are already partially priced into longer-dated finance arrangements.

The underlying credit quality of individual companies will directly affect the price of bank debt, and it may become uneconomical for weaker/un-rated companies to borrow from the bank market. This is not only likely to force the development of a deeper and broader high-yield market in Europe, but will make the tranching technology of securitisation a very attractive and viable option for lowering the cost of debt.