CHANGING WITH THE TIMES

IT MAY NOT HAVE BEEN THE CASE BEFORE, BUT SECURITISATION IS SLOWLY EMERGING AS A FUNDING SOURCE TO BE RECKONED WITH. **TIM NICOLLE** OF JMH DEMICA TAKES A CLOSER LOOK.

Securitisation is not seen as a mainstream source of finance by most CFOs and treasurers. There are many reasons, in fact, why companies would see it as financing method of last resort. However, in this article we challenge this perception and set out some recent developments that will bring securitisation back onto the agenda for treasurers, whether your business is highly rated or sub-investment grade.

WHAT'S WRONG WITH SECURITISATION? Typical feedback about securitisation from those who have completed transactions generally suggests that they would not willingly do a repeat transaction. Often, deals were more complicated than initially assumed, and there were cost over-runs and time delays. Operating companies did not appreciate the extra work that was involved.

The Enron factor now also looms large, and companies that execute structured finance deals must be looking for 'something from nothing' and therefore hiding financial activity. With apologies to the Lex column (*Financial Times*, 6 January 2003) – does 'Ebitda under IAS' really mean 'earnings – but I tricked the dumb auditors into accepting a securitisation?'

BUT TIMES ARE CHANGING. There are new financial and systems technologies available that allow a simpler form of securitisation to be completed that can be on- or off-balance sheet and can be accounted for as a straightforward financing transaction. Specifically, the criticisms levelled at securitisation historically are now being addressed. This is relevant to corporate treasurers and CFOs everywhere. The key points are:

- securitisation funding is often substantially cheaper than bilateral finance – savings can be millions of euro a year;
- corporate liquidity is tightening and finance may no longer be freely available; and
- new banking regulations (Basel II) mean that capital weightings for bilateral loans will go up (potentially to 150%) and capital weightings against structured assets (for example, a securitisation) will go down (potentially to 20%).

Most importantly, the new technologies have extended the range of companies that can consider securitisation. This includes businesses that are unrated or rated below investment grade, have many operating companies, and use a diverse range of systems and accounting practices. Consequently, securitisation should be on the agenda of every CFO and treasurer.

THE CURRENT POSITION. Most corporations have taken advantage of accommodating banking markets over the past few years to raise competitively-priced finance. Our analysis of corporate liquidity suggests that most are well-funded, with very few major calls for repayment arising within the next 18 months. Aside from acquisition-related transactions, the core debt facilities supporting most corporate balance sheets will see most businesses through any tightening in funding availability during 2003. However, looking further ahead, the picture is less clear.

BANKING FINANCE. Banks are increasingly reviewing the lines of credit and finance that they make available to the manufacturing and industrial sector. This trend reflects a perceived deterioration in credit quality across companies of all sizes and nationalities, and an atmosphere of caution prevails, given the threat of recession and a lack confidence, post-Enron.

The quarterly credit review from Standard & Poor's backs up this view. The review notes that "Global credit quality stalled in the third quarter [2002], mirroring economic events during the period". It goes on to point out that some 500 downgrades occurred in the six-month period to September 2002, compared with only 150 or so upgrades.

There is a further complication. As already mentioned, the proposed new banking regulations (Basel II) will lead to significantly higher capital charges on lending to companies rated below BBB (sub-investment grade credits). In future, loans to this sector will attract a high capital weighting – up to 150%. This compares to a reduced weighting for higher rated assets – for example, an AA-rated asset will attract only a 20% capital weighting.

Companies cannot ignore the pressures faced by their relationship banks. On the one hand, credit committees are restricting the capacity to lend, while on the other hand, regulators are tightening up the rules on capital allocation.

SECURITISING INVOICES. Securitisation involves financing trade debts that are originated by operating companies within the group through a wholesale arrangement. Typically, transactions are executed in size (from €50m upwards) and achieve a funding cost in the region of between 50 and 150 over Libor all-in.

This is not a new concept – there are some $200bn of financings outstanding in the US market on this basis. As this article goes on to describe, what has changed is how the structures are put together and how the reporting is achieved that is needed to maintain the rating.

The securitisation delivers a financing that has an AA rating (or an A1+/P1 short-term rating). This may be rated much higher than the company's own balance sheet. The uplift in rating is achieved in two steps. First, a debtor book is constructed that represents a diversified portfolio of credits that can be insulated from the credit worthiness of the originator. Second, the debtor book is combined with a range of banking facilities to ensure timely payment of any financing arrangement.

Historically, such an arrangement would not have been easy for the typical multinational group. With operations in different industries and in different countries, there is usually no centralised accounting or tracking system, and operating companies are often fiercely independent. This requirement can now be met as result of new software technology that delivers the necessary reporting and tracking without disrupting the existing IT infrastructure or interfering in local operational matters.

A further barrier would have been the credit rating of the company itself. In the past, structuring technology did not effectively insulate the debtor book from the creditworthiness of the originator (in other words, the originator remained a dependent credit). Consequently, securitisation funding was really restricted to companies rated A and better. This has also changed as a result of new rating and financing technologies that have recently been pioneered – creating an effective legal and practical isolation of the debtor book from the parent company balance sheet – again, without disrupting local operating company operations and customer relationships.

THE FUTURE OF RATED ASSET POOLS. There is a further shift in activity that is currently being discussed, driven by regulators and the changing needs of the banks. This involves a brand new rating concept that has been called the 'pooled obligation ratings'.

At present, credit ratings are applied to securities that are issued to the market. The rating normally relies not only on the credit quality of receivables, but also upon a range of other banking facilities and arrangements. The new idea is to apply the rating to the receivables themselves (that is, the collected obligations of selected debtors, administered to a particular standard). Instead of selling receivables to a securitisation-financing vehicle (a special purpose vehicle, SPV) and then issuing paper to the market, the rated asset pool could simply be purchased by a bank directly (similar to an invoice discounting arrangement).

The resulting asset would be, for instance, publicly rated AA and so may attract only a 20% risk weighting – making it attractive for a bank to hold. This would be a viable alternative to the traditional conduit financing, where the banking facilities provided are under close scrutiny from regulators and may well attract an adverse capital treatment. So why bother with the complexity if a similar and sensible result can be achieved directly?

What this innovation will mean is treasurers and CFOs gain much more control over who finances their assets, effectively developing a brand new set of banking relationships, but where there is much greater flexibility as a result of the public rating obtained.

TABLE 1
THE SECURITISATION CHECKLIST

	Question	Answer
1.	What does it do?	A securitisation of trade receivables will make sense for any CFO or treasurer currently concerned about: ▪ reducing funding costs; ▪ bank facilities that are to be repaid in the next 18 months; ▪ diversifying funding sources to reduce reliance upon banks; and ▪ funding acquisitions.
2.	Is it possible?	A securitisation should be possible if: ▪ there is an outstanding debtor book of €75m or more in operating companies based in major economies – such as western Europe and the US – it does not matter how many operating companies this book is spread over; and ▪ the terms of trade mean that invoices are usually settled by payment rather than by credit note or return of goods.
3.	But what about?	Critically, the new technologies mean that a transaction can be completed even if: ▪ the parent company rating is below investment grade or is unrated; ▪ the invoices are spread over many operating companies; ▪ everyone has different systems, databases, customer lists, banking practices and the like; and ▪ operating companies are independent of head office and do not want to be troubled by a transaction.
4.	What next?	An informal review of activity and processes can determine the potential viability of a transaction relatively quickly.

THE PRACTICALITIES. There are many ways in which organisations seek to centralise information on their receivables – ranging from a simple monthly spreadsheet that shows debtor balances and turnover – to a real-time monitoring system that tracks the issuance of each invoice and the cash it subsequently generates.

Securitisation, particularly for companies rated below investment grade, requires a high level of tracking, ideally in real-time (that is, central recognition of cash as it is received locally). Inevitably, this involves a processing capability that is not, typically, built into the existing infrastructure of the corporation accounting systems. But all is not lost.

A new generation of financial systems has been developed as an 'overlay' to the existing accounting infrastructure, which can provide the online reporting necessary for securitisation. This overlay technology can usually be implemented in a matter of a few weeks and provides a real-time tracking environment for all transactions across an enterprise, without disrupting local operations.

A NEW ERA FOR SECURITISATION. A combination of pressures and new developments is bringing securitisation to the top of the CFO agenda for all companies – whatever their rating and complexity level. Ultimately, this will herald a new era where structured finance structures are used by companies to raise finance without artificial accounting outcomes, and where the structures are rated and owned by the companies themselves.

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