Securitisations – a different view

In the September edition of *The Treasurer*, Stephen Moller of Simmons and Simmons painted a very positive picture in *Securitisation – a safe bet for your assets*. Our view, however is rather different. Whilst we agree that there is a place for securitisations in mortgage-backed property, and some other specialist sectors, there can be drawbacks associated with managing them which means that they are not so suitable for more traditionally structured companies.

Securitisations convert bundles of assets into structured financial instruments which are then negotiable (or tradeable). They raise funds which are backed by specific assets or by income flows, and a particular feature is the strict 'ring fencing' of particular assets or cashflows. This means that the financial instruments – such as medium term loans or commercial paper – can be assigned a higher credit rating than the actual borrower could command in their own right. This makes this kind of facility attractive to borrowers which are either unrated or have low ratings. As a result the issues usually need to be rated by the rating agencies – Moody's and Standard & Poor's. Road shows or presentations have to be prepared to explain in detail the activities and financial background to the company and the proposed loans, to those agencies and potential investors.

The important feature which gives the debt issue a higher rating, is the guarantee to the investor that if the borrower ceases trading for any reason, their loan is secure and will still be repaid. But what are the drawbacks?

Complexity – As the description suggests, securitisation or structured finance carries with it a very specific structure, which can be very complex and may restrict the borrower from having immediate access to some of its day-to-day cashflows. This also means strict adherence to a whole series of ratios, focusing on optimum cash generation.

The securitisation structure will probably require the establishment of new 'bankruptcy remote' companies to issue the debt, to receive the proceeds of the loans, and to handle the receivables. These companies each need access to bank accounts, and, more importantly, the accounting needs to be more specific than within the conventional company structure. The assets eligible for the securitisation would need to be separated into these bankruptcy remote companies both in a legal and accounting sense. The cashflows will also have to be segregated, and the bank accounts may also need to be able to provide a range of sub-accounts to cover reserves which may have to be made to cover a series of different provisions which the structure requires.

If the existing accounting function is run in a typically frugal manner, additional personnel will almost certainly need to be employed because of the immediacy and detail of the reporting and accounting which is required.

The structure is managed for the borrower by the security trustee which will probably be provided by the lead bank.

The structure may well result in pools of cash being held separately within the 'ring fence' which can be managed to earn interest in a specified manner.

The documentation is voluminous in the extreme, requiring several dozen interrelated agreements.

Reporting – The complexity of the structure requires a much higher degree of reporting than under more usual banking facilities. Daily, weekly and monthly reporting of cash positions and asset information, including relevant ratios, can be required. Information on assets will include details of individual assets providing the underlying security, both fixed assets and current assets, in order to determine the borrowing base. Eligibility assessments against the assets and daily reporting of cash collections and billings is a standard feature. The ratios may be further affected by the level of debt payment defaults, and other business data specific to the borrower or securitised assets.

Cashflow management – Perhaps the most significant disadvantage is that because of the fragmented nature of the cashflows which are either within or outside the arrangement, it is no longer possible to manage the corporate liquidity using conventional treasury techniques of pooling bank account balances. Bank accounts handling the cash on the securitised assets will be segregated from general pooling arrangements, although they may be allowed to pool amongst themselves. As the cashflows relating to the securitised assets or revenues pass straight to the security trustee, the amount of cash being passed on to the borrower by the security trustee may not be known, and certainly not received until well into the working day, by which time interest rates on the money markets are often past their best. Similarly, payments relating to the operation of the company may have to be delayed until the cashflows are received from the security trustee.

Activities outside of the securitisation – Although other company activities may continue outside of the securitisation, it could be that they will be restricted, by the existence of a prior charge over the entire company's assets, or by the fact that all the borrower's 'good' assets are tied up in the securitisation. This could impact on existing bank relationships, other borrowing facilities including overdrafts, and the ability to negotiate new business outside of the facility.

Additional advisors – Securitisations carry with them a multitude of professional advisors including the lead bank, which will probably also act as the funding agent and the security trustee. That bank will appoint its own lawyers which will also act for the other banks, but the borrowing company also needs to be advised by its own lawyers. There may also be the need for other professional trustees. Other parties to the documentation, such as the main clearing bank will also consult its own lawyers concerning their own aspects of the documentation.

In addition, the borrower's auditors are likely to be called upon not only to undertake audits of the assets and the reports, but also to provide various certificates concerning the assets and cashflows, tax positions and contingent liabilities. Auditors in general are becoming increasingly unhappy about these certificates because of the increasing reliance which is being placed on them, and therefore need to be involved in the negotiations at a fairly early stage.

As previously described, the rating agencies play a big role in the structure of the deal and considerable management time will need to be spent with the Lead bank and Standard & Poor's and Moody's.

Needless to say, all of these advisers have to be paid for – most of them, whether the transaction is completed or not.

Contingency arrangements – The documentation for a securitisation is based on ensuring that the loans will be repaid if the borrower fails. To date, only one company which had securitised its borrowings has failed, and the structures which had been created enabled all of the lenders to be repaid in full. However, it does mean that very detailed contingency plans need to be prepared to assure the security trustee that it is able to step in to realise its security if necessary. As a result, very difficult issues may need to be raised with trading partners, suppliers and service providers to assure the security trustee that the operations will continue to function to enable the assets or revenues to be realised in the event of a failure.

Companies only usually start to ask such questions if there is some risk of the possibility of failure, and the mere asking of the question can cause unjustified uncertainty.

Understanding – Complexity and reporting requirements are the true (and heavy) aspects of securitisation but they can be useful and have positive effects on the business information systems, accounting and management tools of the company. Indeed, undertaking a securitisation can force you to understand and organise better, and in more depth, the business you are doing, the way you are doing it and the risks you are taking. Securitisation can help enhance the information systems and organisation of a company and makes full sense if integrated into the company's forward strategy. Clearly securitisation can only be used for large volume operations and repeat deals… because the economies of scale are large.

Mr Moller predicted that the growth in securitisation is set to continue, as the awareness of the technique on behalf of borrowers increases. We hope that this outline of the practical considerations in this response will enable potential borrowers to make a balanced judgement on this technique. ■

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[1] *The ACT Companion to Treasury Management*

E-fan hits back

In last month's Association pages (*Sun, sea and scepticism*, page 67), David Creed gave us the benefit of his beach musings on e-commerce. I was surprised to see David expressing scepticism on the benefits of e-commerce and even more surprised by his views that the future of financial trading is for companies like BT to trade its debt and equity on its own website. My, David, the sun must have been strong!

The point is interesting because I firmly believe that exactly the opposite forces will be at work, and indeed there is ample evidence of this already. BT's core business is telecommunications, not trading financial securities, and we are very pleased to use the services of those who are best placed to facilitate liquidity in our financial instruments. For the same reasons, we choose to use commercial paper dealers rather than issue direct to the market. Those dealers provide us with a valuable distribution service in a market where buyers have a choice – the choice to buy, for example BT or France Telecom paper. On any given day, those investors need to be educated about credit and pricing issues, something best done by efficient market intermediaries.

All of this will of course be accomplished within an increasingly sophisticated e-commerce environment. Already, I have a highly sophisticated offering from Morgan Stanley available on my PC, via the internet, which is automatically configured to present me with comprehensive investment banking and capital markets information relevant to my company's needs. Relevant presentations can be securely posted to the site and regularly updated, leaving me with paperless and continuous access to all relevant data without endless meetings and phone calls. Securities are already and will increasingly be sold on the internet; indeed if David Creed would like proof of the power of e-commerce he need look no further than the collapse in profitability of the entire money broking industry.

The real forces of e-commerce will be deployed to enable companies to focus to a much greater degree on core competencies. Vast swathes of previously strategic non-core business processes will be outsourced to companies who can do them cheaper and better. Examples are billing, accounting, payroll, procurement, pension administration, human resources, security, safety and vehicle fleet management. Which brings me to David's scepticism about e-commerce. There are now close to one billion mobile phone subscribers globally. In BT's world, data accounts for more than half of all our fixed line network traffic. Third generation cellular services will soon permit electronic organisers to be truly interactive, very fast, and totally, globally, mobile. Are you still sceptical, David and are you really sure that you don't feel just a little complacent?

A footnote – I have not personally bought either a book or a CD from anywhere other than Amazon.com over the last 18 months. And that includes a book that David recommended to me about climbing Kilimanjaro (which otherwise I would have had to trek half way round London to find!). ■

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