

Securitisation – after the credit crunch: is it right for your business?*



An expanding market

Mention ‘securitisation’ and one may think of on-off balance sheet, manipulation, Enron and Parmalat; others think of investment bankers, obscure language, high fees and toxic asset classes in the credit crunch.

Securitisation undoubtedly received a lot of adverse press in the early days of the credit crunch, primarily in respect of structures that depended on the cashflows arising from underlying US subprime loans, great numbers of which defaulted. While the primary cause of difficulty for investors in the securities of such structures was the underwriting of these loans, further difficulty arose where there was a lack of transparency as what assets underpinned a given structure, particularly in CDO squared and other highly leveraged vehicles, which made identifying and managing the risk on these investments harder. In respect of the originations themselves, the originate and distribute model has been criticised for allowing a divergence of originators and investors interests in the ongoing performance of the loans.

The industry and regulators have reacted to these issues however, with increased transparency, some form of compulsory retention of interest by originators and simpler structures being the principal solutions looked to. In addition, securitisation is increasingly being looked to, by the UK and European legislatures and central banks, as an important tool to deploy in their efforts to increase bank lending. These include security guarantee schemes, designed to underpin bonds with a government guarantee, restore investor confidence and so create new funding that will allow new lending, and an increase in availability and use of central bank repos for the highest quality asset backed securities for the same purpose.

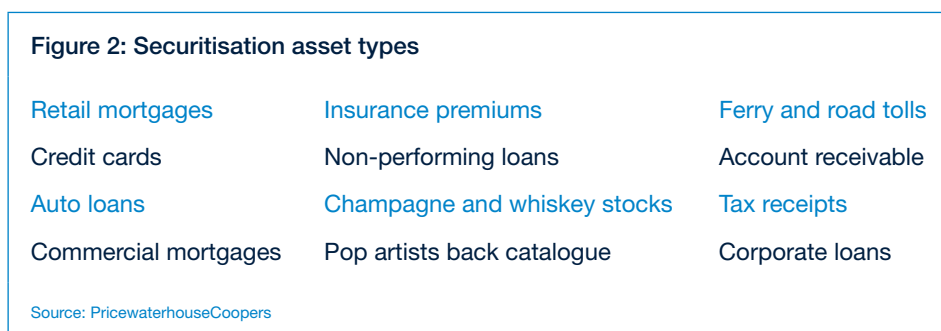
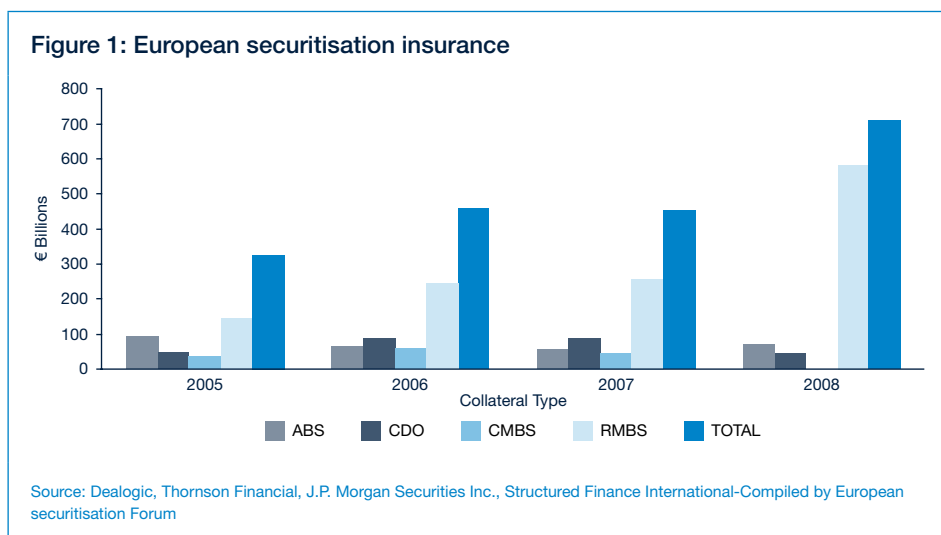
It is undoubtedly true that securitisation is complex, but equally true that it remains an important tool for many companies, both within and outside the financial

services sector. We believe there are good reasons as to why growth will continue, and they will be addressed later in this article.

Securitisation techniques were developed in the US in the 1980s, and has become a mature and significant sector of the capital markets. In Europe, a few securitisation transactions were undertaken in the 1980s, but it was not until the late 1990s that the market exploded. As can be seen from Figure 1 below, it has been growing ever since at an increasing rate.

In other parts of the world, Australia has a mature mortgage securitisation market and is just beginning to develop other asset classes. Japan has a domestic market, and some other Asian countries have experimented with securitisation. We have recently seen the first deals in Russia and the Middle East.

Many types of receivables and assets, that will generate future receivables, have been securitised. Some of these are listed in Figure 2.



So how does securitisation work?

A company (the originator) wanting to securitise will transfer current or future receivables to a Special-Purpose Entity (SPE). This transfer needs to be what is known as a ‘sale/true sale,’ meaning that in the event of the originators’ bankruptcy, the assets will remain the property of the SPE and will not be available to the originators’ creditors.

The SPE pays for the assets by raising funds through the issuance of securities in the marketplace, either public or private. Conduits are a popular vehicle utilised to fund short-term assets. The sponsoring bank may consolidate a conduit. It is a particularly useful structure for smaller transactions and shorter-term assets.

Before arranging this funding, the SPE should consider currency and interest-rate hedges, as well as credit enhancement for the assets.

Credit enhancement means that in the event of losses, often three or four times expected losses, the originator or a third party (e.g., an insurance company) will absorb the losses.

Credit enhancement can take many forms, including a subordinated loan from the originator, credit insurance and cash reserve funds (being cash built up of cash in the SPE). This credit enhancement allows the SPE to be highly rated, thus enabling it to raise funds at highly competitive rates.

Any excess income in the SPE, after paying the funding costs, hedging costs and other expenses, is usually passed back to the originator as deferred consideration. Usually, the originator will continue to service and administer the receivables on behalf of the SPE. It is thus more attractive than an outright sale of the receivables, because it provides funding, and a limited amount of downside protection (in respect of losses incurred above the credit enhancement), while maintaining all the upside potential of the assets. It also maintains the ongoing relationships with customers, and usually, they may never know that their receivables have been securitised.

A key to making a securitisation effective is to ensure that it is ‘tax neutral’ as far as possible both from a direct and indirect tax perspective. In some jurisdictions, this is relatively easy whilst in others ‘offshore’

SPEs are required. Tax opinions will be produced to show there is no significant tax cost as a result of the securitisation.

The net result of the structuring is that the originator has raised funding whilst maintaining the right to the profit on the receivables.

So why is securitisation attractive to companies?

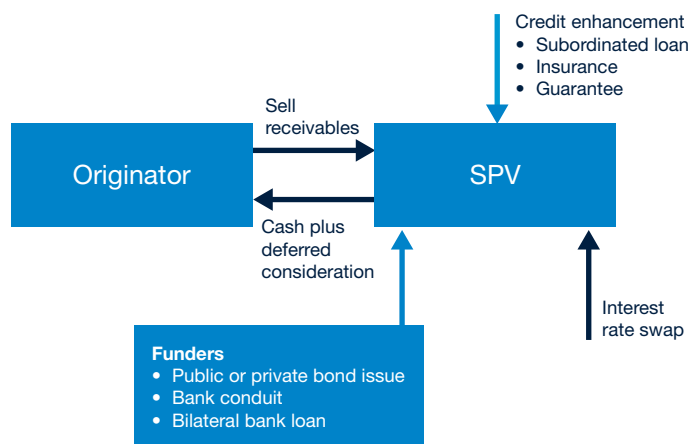
It enables a company to raise funding not linked to its credit rating. This enables companies to raise funds from sources that would not normally consider funding such a company. It also does not utilise existing funding lines or limits.

Because of the high credit rating of the SPE, overall funding may be reduced. This will become particularly important as banks adopt Basel II and will have higher capital changes for lending to unrated and lower rated companies.

In addition to being an effective funding technique, securitisation may provide other benefits. It may be used as a risk mitigation tool, for catastrophic risk. The originator bears the cost or pays for protection in respect of three or four times expected losses. If losses are greater than this, the note holders bear these losses.

Depending on your accounting programme, which will be discussed later, securitisation may result in earnings when assets are securitised.

Figure 3: How can you use securitisation to access the capital markets?



Source: PricewaterhouseCoopers

Case study:

A Scandinavian privately owned company manages a number of retail outlets and has its own in-house store card. It is unrated, because its owners do not want to submit to the intrusive rating process. Traditionally, it has funded itself through bank loans. The rate on these were good, because of the company's track record and reputation. The company was told that in anticipation of Basel II its funding cost would rise by 100bp. The company developed a securitisation programme for its store card receivables and obtained funding around 30bp above its historic level, thus saving 70bp.

A frequent comment from first-time issuers is that the process enables them to understand their receivables better and enhance their origination and processing systems giving them a further competitive advantage.

For companies in developing countries, where traditionally international lenders have been unwilling to lend due to the political and country risk, securitisation can be particularly beneficial. By having the SPE outside the originators country and in an established financial centre, much of the political and country risks can be removed.

Many people associate securitisations with off-balance sheet accounting and some of the recent scandals mentioned earlier. Undertaking a securitisation purely to 'massage' the balance sheet is never a good reason for undertaking such a transaction. Equity and credit

analysts are increasingly penalising companies where it is not clear why securitisations have been executed.

On the other hand, the same analysts give significant credit to companies which use securitisations in a strategic manner and can articulate the reasons for doing so. Those who combine this with good and clear financial and disclosure risks on the securitisations have nothing to fear.

In any event, in practice 'off-balance' sheet accounting is getting more difficult. US GAAP is relatively friendly to securitisations with its qualifying special purpose entity (QSPE) regime, but in recent years the FASB has tightened the rules for qualifying as a QSPE and new rules likely will be stricter.

Under IFRS, most traditional securitisations fail to achieve off-balance sheet treatment (although there is some possibility of partial derecognition) consequently, the securitised assets

remain on the balance sheet with the originator bringing on to its balance sheet the funding obtained.

Currently, there is an intention to converge US GAAP and IFRS, which in the case of securitisations will not be easy. The securitisation industry world-wide is currently working to develop an accounting approach that will best account for the complex economics of a securitisation. This is an initiative of the European, Australian and US securitisation forums, which have to date undertaken a worldwide survey of the accounting needs of securitisation and how current accounting regimes meet these needs. The results of this survey have been discussed with IASB, FASB and other regulators. We would encourage all securitisers to get involved with this initiative and to provide their ideas for the future. The authors would be pleased to receive your comments.

Accounting has, however, become less important in many parts of the world (outside the US) as regulators have developed their own rules for determining regulatory capital requirements, and this is also the approach Basel II takes.

Case study:

A Caribbean company with a major export business wants to raise funding for expansion. This funding cannot be sourced from the limited domestic markets, and international funders are reluctant to lend in the region. The company sets up the SPE in Delaware and sells its export receivables to the SPE. The SPE then arranges funding from a US and EURO Medium-Term Note (MTN) programme. This is possible because the funds from the receivables are kept offshore, while the MTNs are outstanding.

So what do you need to do to undertake a securitisation?

The first step is to undertake a feasibility study, which would include asking the following questions:

- What strategic imperative does it solve?

- Do the expected economics make sense?

- Do we have suitable receivables;
 - that can be legally transferred?
 - that have a verifiable track record?

- Do we have systems that can segregate and manage the receivables?

- Are there any other issues or advantages to be gained?

- Will there be investor demand?

- Is there anything that will make a securitisation impossible?

Only after these key questions have been answered should you proceed to commit to investment bankers and lawyers to develop a detailed plan and structure.

Conclusion

Undertaking a securitisation is a complex business decision requiring many functional areas of a company and a number of external professionals. While securitisation professionals have a unique language, the fundamentals are fairly simple.

Securitisation is a technique that will become relevant and helpful to more and more companies. It can be complex to undertake, but with careful planning and project management, is achievable for most companies. In the future, we foresee it being a necessary funding technique for many companies rather than an exotic option.

It is for this reason that at PricewaterhouseCoopers we have developed a global securitisation practice, which helps clients make complex business decisions in undertaking a securitisation as easy as possible. Our practice with major centres in the US, Europe and Australia, and we work with both the largest securitisors in the world, as well as those undertaking their first securitisations. Our global practice takes the best experience and knowledge from

around the world and helps clients develop a securitisation process to enhance their businesses. The authors of this article are significant members of the various securitisation trade bodies, that continue to influence major market developments.

The global practice has written 'A Guide to Global Securitisation Transactions' and 'The Practitioners Guide to Securitisation' (on behalf of City and Financial), which while written from a UK perspective, will be of value to all first-time securitisors.

Case study

An Australian bank needs to reduce its regulatory capital requirement as a result of an acquisition. It has a big credit card portfolio and wants to explore if securitisation of its credit cards will solve the problem. PricewaterhouseCoopers has been appointed to undertake a feasibility study. This study takes four weeks and concludes that a credit card securitisation is feasible, but that certain systems enhancements are required. These system enhancements have been started, together with detailed planning. PricewaterhouseCoopers has been appointed Project Manager. To speed up the process, an initial securitisation is undertaken, using a US bank conduit with plans for a public bond land issuance as a second step.

Contacts

Peter Jeffrey

PricewaterhouseCoopers (Europe)
Tel: +44 (0) 20 7804 5214
Email: peter.c.jeffrey@uk.pwc.com

Mark Davis

PricewaterhouseCoopers (UK)
Tel: +44 (0) 20 7212 4011
Email: mark.w.davis@uk.pwc.com

Peter Flick

PricewaterhouseCoopers (Germany)
Tel: +49 69 9585 2004
Email: peter.flick@de.pwc.com

Mike Byrne

PricewaterhouseCoopers (Jersey)
Tel: +44 1534 838278
Email: michael.j.byrne@je.pwc.com

Paul Landy

PricewaterhouseCoopers (Netherlands)
Tel: +31 (0) 20 5684284
Email: paul.landy@nl.pwc.com

Anik Chaumartin

PricewaterhouseCoopers (France)
Tel: +33 (0) 01 5657 8038
Email: anik.chaumartin@fr.pwc.com

Guenter Simon

PricewaterhouseCoopers (Luxembourg)
Tel: +352 (0) 494 848 2375
Email: guenter.simon@lu.pwc.com

Mark Tracey

PricewaterhouseCoopers (Portugal)
Tel: +351 213599316
Email: mark.tracy@pt.pwc.com

Alain Lattafi

PricewaterhouseCoopers (Switzerland)
Tel: +41 (0) 58 792 9433
Email: alain.lattafi@ch.pwc.com

Padraic Joyce

PricewaterhouseCoopers (Ireland)
Tel: +353 (0) 1 792 6394
Email: padraic.joyce@ie.pwc.com

www.pwc.com

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