

FIRST TIME ORIGINATOR'S GUIDE TO SECURITISATION

Originators can use securitisation to achieve a lower cost of funding than from other debt products and to remove securitised assets from their balance sheet. Securitisation plays an important role in facilitating liquidity and risk management, allowing originators to diversify funding sources, mitigate balance sheet risks and optimize capital allocation. Through unlocking asset value and improving market liquidity, securitisation can contribute to economic growth, facilitate access to capital for businesses and support financial stability.

Securitisation is a form of structured financing, whereby the credit risks associated with a specific pool of assets are segregated from the originators' own credit risks. This is typically achieved by establishing a special purpose vehicle ("SPV"), which purchases the asset receivables from the originator and subsequently issues securities against these asset receivables to investors. The SPV then disburses principal and interest payments to investors using receipts generated by the underlying assets. By structuring the SPV to hold only the securitised assets, distinct from the originator's group, the originator's credit risks are isolated from those linked to the underlying assets. The originator will, however, maintain customer relationships (with customers not being notified, in the ordinary course, of the securitisation).

HOW TO ESTABLISH A SECURITISATION

An originator's treasurer or CFO, when considering securitisation as a funding tool, may consult with debt advisors or relationship banks to obtain insights into the market and likely pricing/funding economics. An originator's first securitisation is usually established with a single bank as a private funding facility, giving the originator an opportunity to benefit from lower funding costs. A number of banks are willing to provide flexible variable funding that allows funding to be drawn over time, similar to a revolving credit facility.

Different banks provide funding on different terms, and originators must consider different banks' proposed offerings and agree a structure and term sheet that works for the business.

Originators will rely on their advisors to negotiate the structure, termsheet and underlying documentation - securitisations are almost never done on a bank's standard terms, and an originator needs to ensure the terms it agrees to are workable even as the business grows, and in both good and challenging times.

Every originator's assets are different, and putting together a securitisation requires work by both the originator and funding bank in diligencing the assets, including by looking at historical data.

Investors regard asset performance data as very important, and as the originator's business matures (and origination volumes grow) and increasing data becomes available, investors are typically willing to invest on more favourable terms.

Other points of focus in establishing a securitisation include the cash management and collection account arrangements used by the originator and the terms and conditions applicable to the securitised assets. Investors will also typically seek to assure themselves that the way in which the originator deals with underlying customers is consistent with law, regulation and general market standards.

Ultimately, originators may establish a securitisation structure whereby asset backed securities are offered to a range of institutional investors in the public markets, similar to a bond issuance. These structures can give originators the benefit of a very low cost of funding, but are typically only used after an originator has securitised its assets privately for a number of years.

TYPES OF SECURITISATION AND THE UNDERLYING ASSETS INVOLVED

'Securitisation' encompasses a variety of structures tailored to the specific characteristics of the underlying assets and the preferences of originators and investors. These structures differ in their complexity, risk profiles and regulatory treatment. Some common structures include:

Traditional securitisation

Traditional securitisation - summarised in the introductory paragraph above - involves the transfer of a pool of asset

receivables to an SPV. The SPV issues securities backed by these asset receivables to investors. Cash flows from the underlying assets, including principal and interest payments, are used to service the securities. This structure allows originators to monetise illiquid assets and diversify funding sources.

Synthetic securitisation

Synthetic securitisation involves the transfer of credit risk associated with a pool of assets without transferring the underlying assets themselves. This could be by the use of credit derivatives or financial guarantees. Synthetic securitisation can be used for risk management, regulatory capital relief or to create bespoke investment products.

A first time originator would be unlikely to enter into a synthetic securitisation, which is typically used by banks to free up regulatory capital (rather than to obtain funding). Accordingly, synthetic securitisation is out of scope of this briefing.

Whole business securitisation

Whole business securitisation involves the securitisation of cash flows generated by an entire business operation, rather than specific assets. This structure is often used by utilities and companies in industries such as hospitality, healthcare or franchising to monetise future revenue streams.

Underlying assets

A wide array of assets can be securitised, with the most typical being:

- residential and commercial mortgages;
- personal loans and auto loans;
- commercial or trade receivables;
- corporate loan portfolios; and
- credit cards.

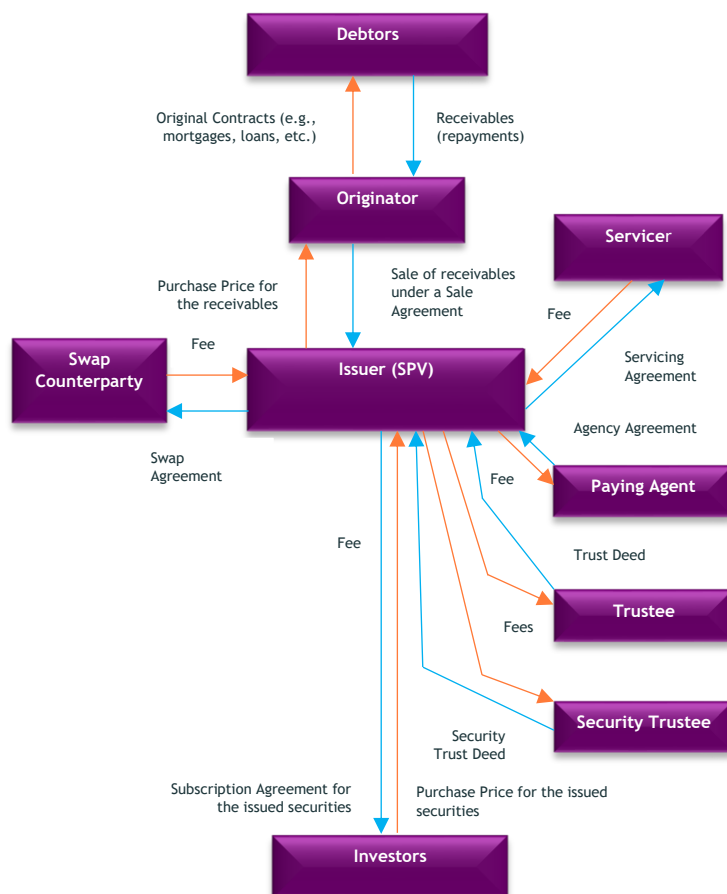
Other less common asset classes that have been securitised in the UK include, among others:

- lease and rental receivables;
- IP royalty receivables;
- insurance premiums;
- healthcare receivables;
- ticket receivables;
- receivables from public utilities;
- mobile handset loan receivables; and
- student loan receivables.

Where the asset pool is limited to financial assets, such as mortgages, auto loans or credit card receivables, the securities issued by the SPV are commonly referred to as 'asset-backed securities' or 'ABS'. The securities are often structured with different tranches, each offering varying levels of risk and return. ABS may be further classified based on the type of underlying assets, such as residential mortgage-backed securities ('RMBS'), collateralised loan obligations ('CLOs') and collateralised debt obligations ('CDOs').

MAIN PARTIES TO SECURITISATION AND THEIR ROLES

Securitisations involve a number of key parties. The following section provides an overview of the parties involved in a traditional securitisation structure.



Originators

The originator is the entity which originates or creates the underlying assets that will be securitised. Originators are typically financial institutions such as banks, mortgage lenders or consumer finance companies, but can also be large corporates.

Debtors

Debtors are the counterparties of the originator in relation to the underlying assets, such as the borrower under a mortgage. The debtors will be obligated to periodically pay amounts to the originator on the terms of the underlying asset, which obligation constitutes a receivable. These receivables form the pool of assets which are transferred to the SPV.

Servicer

The servicer is responsible for administering and servicing the underlying assets, which includes collecting payments from debtors, managing delinquencies and defaults, and distributing cash flows to investors. The servicer may be an affiliate of the originator or a third-party entity with expertise in asset servicing. Often a back-up servicer is also appointed to ensure a suitable experienced and

creditworthy entity will continuously service the underlying assets throughout the life of the securitisation.

Servicers are paid a servicing fee, which is intended to be sufficient to attract a replacement servicer if necessary.

Issuer (SPV)

The issuer is the legal entity established specifically for the purpose of securitising the assets and issues the securities to be sold to external investors. The issuer will have limited activities and liabilities beyond the securitisation transaction and will also be typically isolated from the originator's group to ensure it is bankruptcy remote (such that the originator's creditors will not have access to the issuer's assets in bankruptcy).

Sponsors

Although not included in the diagram above, some securitisation structures may include a sponsor, which is commonly a highly rated affiliate of the originator. The sponsor acts as a key intermediary between the originator and the investors, by initiating the securitisation process and coordinating various aspects of the transaction (including legal and regulatory compliance, due diligence and disclosure). The sponsor may also provide credit enhancement to increase the marketability of the issued securities.

Investors

Investors are the main creditors under a securitisation, as they purchase the issued securities and thereby provide funding. In return, they will receive periodic payments of principal and interest from cash flows generated by the securitised assets. Investors typically include sufficiently sophisticated persons such as financial institutions, pension funds, insurance companies, asset managers, hedge funds, high-net-worth individuals and large corporates. The risk and return profile of the securities attract investors seeking fixed-income investments with varying levels of credit risk and yield.

Note trustee

The note trustee is appointed on behalf of the investors and is usually a trust corporation or financial institution with dedicated trustee departments. In UK and European securitisations, a note trustee will generally only take an active role where modifications are required to the transaction documentation or to declare a default and accelerate the securities where directed by the investors.

Some securitisation transactions utilise alternatives to the traditional trustee structure, such as a fiscal agent arrangement or owner trust, which can offer different levels of oversight and control.

Security trustee or security agent

The security trustee or security agent holds the benefit of the security interests created in the securitisation on behalf of the secured parties (which includes the investors).

Swap counterparties

Swap counterparties are engaged to manage certain risks associated with the securitisation, such as interest rate or currency risks. Interest rate swaps or currency swaps may be used to hedge against fluctuations in interest rates or foreign exchange rates, thereby mitigating potential adverse impacts on cash flows and investor returns. In the case of currency swaps in particular, they also allow for the securities to be issued in a different currency to the underlying asset. Swap counterparties may include financial institutions, hedge funds or other entities with expertise in derivatives trading.

Legal counsel and advisors

Legal counsel and advisors play a critical role in structuring, negotiating and documenting the securitisation transaction, and will provide advice on compliance with applicable laws and regulations. Legal counsel and advisors ensure that the transaction is structured efficiently and is compliant with market standards and best practices.

Other parties

Various other parties may be appointed or involved in a securitisation transaction depending on commercial need and the complexity of the structure. For example, other parties may include arrangers, investment managers, underwriters, clearing systems, accountants and rating agencies.

KEY TRANSACTION DOCUMENTS

Securitisation transactions require a suite of core documents to provide for the rights, obligations and relationships among the various parties involved. These documents serve to define the structure of the transaction, establish the legal framework and govern the rights and responsibilities of each party. Key documents include:

Sale agreement

The sale agreement governs the transfer of the asset receivables from the originator to the issuer. It provides for the terms and conditions of the sale, including the purchase price, representations and warranties and any conditions precedent to closing.

Servicing agreement

The servicing agreement governs the servicing of the underlying assets by the servicer. It sets out the rights and obligations of the servicer, including the collection of payments in relation to, and administration of, the receivables, the management of delinquent accounts and the provision of information relating to the underlying assets to the issuer and investors.

Offering memorandum / prospectus

The offering memorandum or prospectus is a regulatory and marketing document that provides potential investors with detailed information about the transaction, including

the characteristics of the underlying assets, the structure of the securities being offered, the risks associated with the investment and the terms and conditions of the securities.

Subscription agreement

The subscription agreement governs the purchase of securities by investors. It sets out the terms and conditions of the investment, including the purchase price, the number and type of securities being acquired and any representations and warranties made by the investor.

Trust deed

The trust deed governs the relationship between the issuer, the note trustee and the investors. It provides for the obligations of the issuer and the rights of the investors, including the payment of principal and interest under the securities, the allocation of cash flows from underlying assets and the procedures for default and enforcement.

Security agreement

Under the security agreement, the issuer grants security over the asset receivables in favour of the secured parties (which includes the investors).

Swap agreements

Swap arrangements, such as interest rate swaps or currency swaps, may be used to hedge against interest rate or currency risks associated with the securitisation transaction. These arrangements are governed by separate agreements that outline the terms and conditions of the swap, including payment obligations and termination provisions.

Legal opinions

Legal opinions may be provided by legal counsel to opine on the validity, enforceability and legality of the transaction documents and the securitisation structure as a whole.

OVERVIEW OF THE LEGAL AND REGULATORY FRAMEWORK AND KEY LEGAL POINTS

Securitisation transactions are subject to a comprehensive regulatory framework governing various aspects of securitisation transactions, including structuring,

¹ The UK Securitisation Regulation currently refers to Regulation (EU) 2017/2402 as it forms part of the domestic law of the UK by virtue of the European Union (Withdrawal) Act 2018 as may be amended or replaced from time to time (including, without limitation, by the European Union (Withdrawal Agreement Act 2020) (the “EUWA”). Please note, however, that the FCA and PRA have published replacement rules that will come into force in November 2024.

² Regulation (EU) No 596/2014 as it forms part of the domestic law of the UK by virtue of the EUWA.

disclosure, risk management and investor communication. Key pieces of regulation from a UK perspective include:

- UK Securitisation Regulation¹ (as amended and supplemented by rules and guidance of the Financial Conduct Authority (“FCA”) and Prudential Regulatory Authority (“PRA”))
- Financial Services and Markets Act 2000
- UK Market Abuse Regulation²
- UK Prospectus Regulation³
- Capital Requirements Regulation (for banks)⁴
- Solvency II (for insurers)⁵

The UK Securitisation Regulation, Financial Services and Markets Act 2000, UK Market Abuse Regulation (as well as the Capital Requirements Regulation and Solvency II in respect of relevant entities), as enforced by the FCA and PRA, aim to protect investors by promoting due diligence, transparency and risk retention.

Risk retention

The UK Securitisation Regulation requires originators to retain a 5% minimum net economic interest in securitisations to ensure the alignment of interests and proper risk management. This retention can be achieved through various permitted methods (such as retention of a vertical slice of exposures, a first loss tranche and maintaining exposure to a random selection of assets).

Disclosure and periodic reporting

In addition to the regulatory requirements governing prospectuses and offering memoranda under the UK Prospectus Regulation, the UK Securitisation Regulation mandates specific disclosure requirements for securitisation transactions. These include disclosure of asset-level performance data, transaction documents and investor reports. Originators and issuers are jointly responsible for providing this information, with the originator often designated to fulfil the requirements in practice. For public securitisations (where a prospectus is required), the information must be made available through an authorised securitisation repository. For private securitisations, this information is generally accessible to investors and relevant authorities.

EU Regulation

At present the EU securitisation regulations⁶ contain very similar risk retention and disclosure requirements for originators. Some originators may in practice need to

³ Regulation (EU) 2017/1129 as it forms part of the domestic law of the UK by virtue of the EUWA (as amended and supplemented by rules and guidance of the FCA).

⁴ Regulation (EU) No 575/2013 as it forms part of the domestic law of the UK by virtue of the EUWA.

⁵ Directive 2009/138/EC and Commission Delegated Regulation (EU) 2015/35) as they form part of the domestic law of the UK by virtue of the EUWA.

⁶ Regulation (EU) 2017/2402 and associated standards.

comply with both UK and EU regimes in order to attract funding from a wider range of providers, and in these cases, originators will need to consider carefully and take more detailed legal advice as to the risk of future divergence between the UK and EU regimes.

ADVANTAGES AND CHALLENGES ASSOCIATED WITH SECURITISATIONS

Securitisation offers unique advantages to originators, and the opportunity to obtain a lower cost of funding than through other debt products. Securitisation allows for the isolation of the originator's credit risks from those linked to the underlying assets. This separation ensures that investors primarily bear the credit risks associated with the underlying assets (rather than the originator's business generally). In addition, through the securitisation process (and particularly where credit enhancement is utilised), the risks associated with the underlying assets are mitigated, making the securities attractive to more risk-averse investors and thereby lowering funding costs for the originator.

Furthermore, by transferring the asset receivables to an SPV, an originator effectively removes the securitised pool of assets from its balance sheet; reducing gearing and freeing up capital for additional investment. Another advantage of securitisation is its ability to unlock liquidity in respect of illiquid assets.

However, while securitisation offers potential advantages to originators, navigating its complexities poses challenges. Establishing a securitisation structure is inherently a document-heavy process, which can be expensive and time-consuming. The complex legal and regulatory framework creates further obstacles, particularly where a transaction is structured with multi-national components.

Ultimately, the decision to pursue securitisation will depend on individual business needs, with the benefits of the mechanism weighed against the associated costs and completion timelines. Despite the challenges, securitisation remains a valuable tool in structured finance, offering unique advantages for originators.

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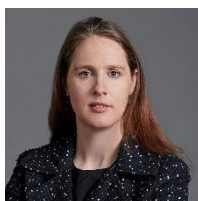
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