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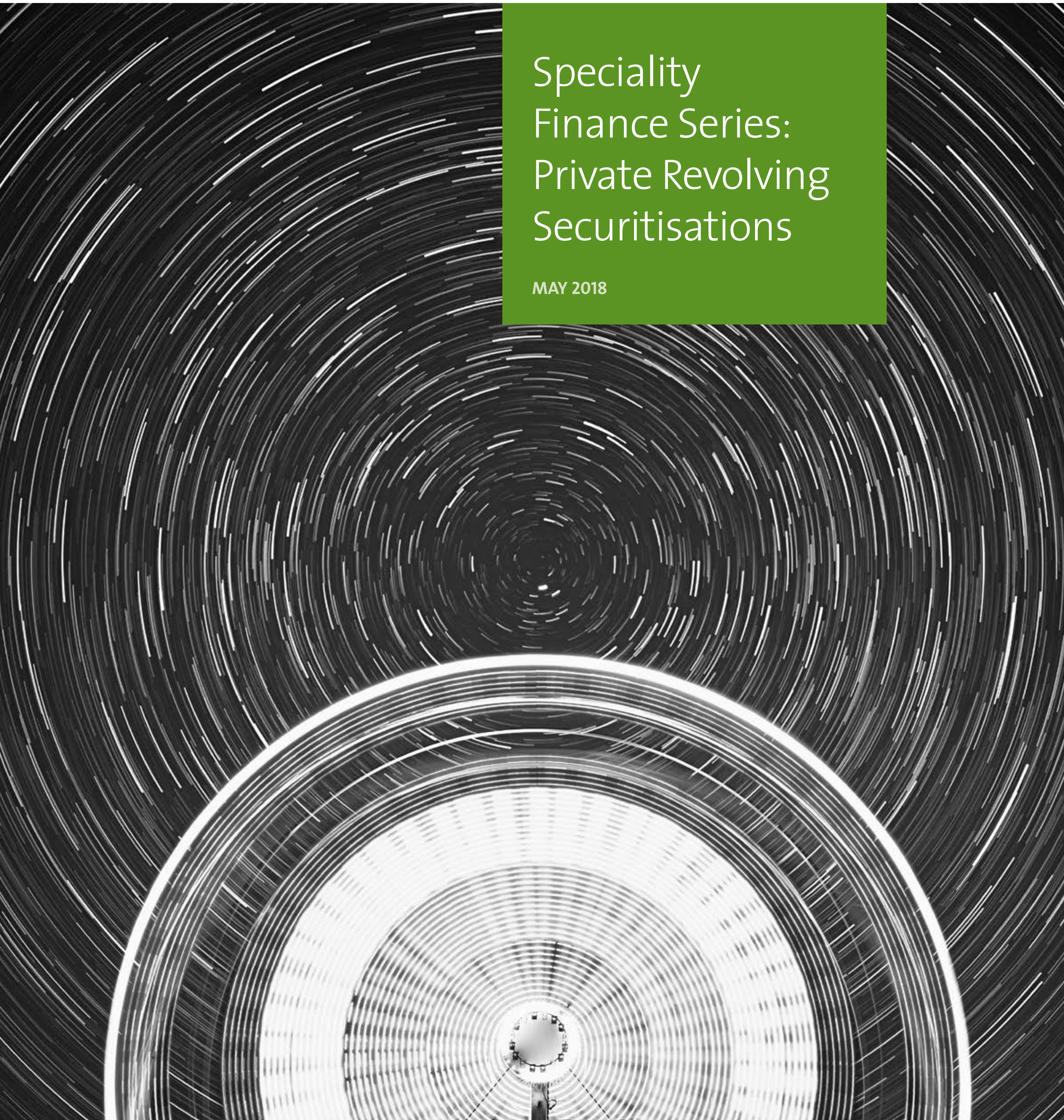
Speciality Finance Series: Private Revolving Securitisations

MAY 2018



Private Revolving Securitisations

An emerging trend in respect of financing solutions for originators of speciality finance products has been the use of asset-backed financing structures that sit between a full rated public securitisation structure and more conventional bank facilities provided by lenders. Whilst a number of different asset-backed financing structures have been implemented by speciality finance originators, such structures often diverge in similar respects from full rated public securitisations.

The private asset-backed structures being implemented by speciality finance originators are typically described in the market as "private revolving securitisations" and, in broad terms, involve funding by a small number of investors on a limited recourse basis to a special purpose vehicle (SPV) established by an originator and secured on a portfolio of speciality finance assets to be acquired by the SPV from the relevant originator throughout the life of the transaction. The investors will fund a percentage of assets (that are determined to be eligible) through a variable funding note (VFN) (or loan equivalent) with the originator funding the remainder of the portfolio through a junior note or loan.

In this note, we look at the renewed interest in private revolving securitisations, which, whilst eliminating some of the complexity related to a full securitisation structure, at the same time offer potential originators access to funding lines not previously available to them. Such structures also allow investors, who are willing to lend on an asset-backed basis, exposure to a broader spectrum of asset classes that in many cases are being originated by lenders at an earlier stage of growth than would be the case in respect of a full public securitisation.

Why?

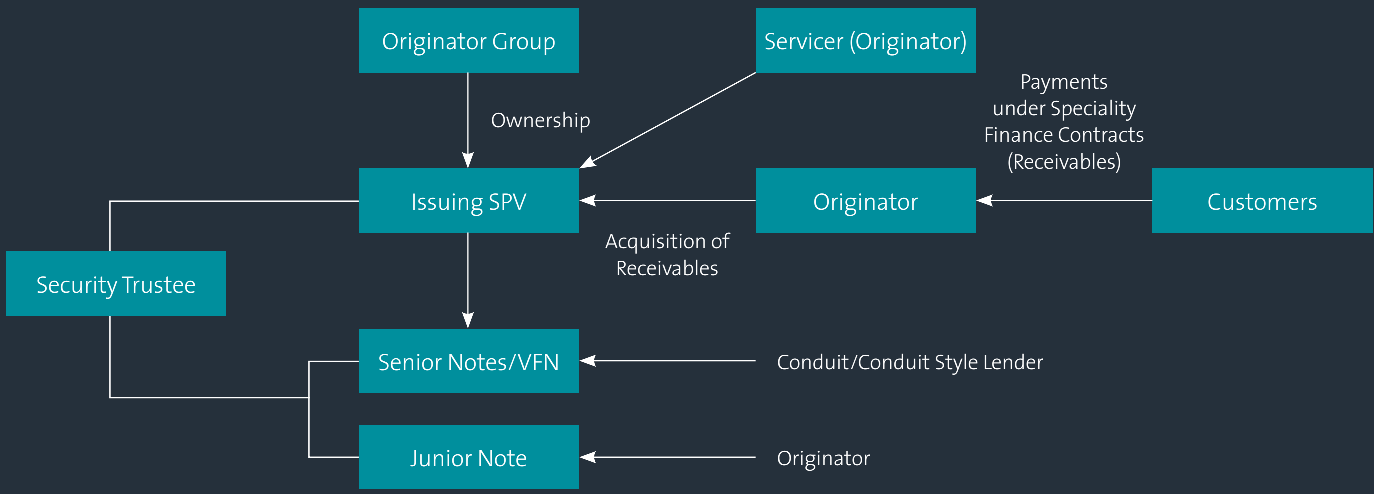
Securitisations may be complex. There is a growing demand from speciality finance providers for a form of financing that uses securitisation, but removes or modifies elements of a typical securitisation structure that, at an early stage in the originator's life-cycle, introduce unnecessary complexity and cost. Some of the key differences are drawn out on pages 6 and 7.

The yields demanded by traditional investors relative to the high fixed costs of a full public securitisation, in cases where the Portfolio Value is less than £150m, may mean private issuance is a more economical route to gain traction with participants usually more active in the public markets.

Whereas the use of private asset-backed warehouse facilities is a well-known financing technique, such warehouses are often used as a precursor to a refinancing via a full rated and listed public securitisation. This is often the case in respect of established securitisation asset-classes such as prime residential mortgages or credit cards. In the case of speciality finance originators, private revolving securitisations may be implemented as a more permanent funding solution where such full securitisation exit may not be required or indeed desired by the originator or the relevant investors.

Flexibility. Given the nature of originators likely to be interested in these structures, an ability to upsize, or indeed downsize funding, subject to market conditions and changes in the relevant originator's overall portfolio of assets is an attractive differentiator. In comparison, public securitisations will often require mandatory redemption of funding as the securitised assets pay down or according to an agreed repayment schedule.

Simplified Structure



WHAT ARE SPECIALITY FINANCE PRODUCTS? A REMINDER...

Speciality finance can be described as financing that takes place outside of the traditional banking system, often targeting smaller niche markets and customers across the credit spectrum. It includes products such as:

- Auto finance
- Bridging Loans
- Asset Finance
- Marketplace lending/P2P
- Point of Sale
- Invoice Financing
- Second charge lending

Key Features

Unrated – but with the originator/servicer able to make rating agency standard data available to facilitate a rating in future in respect of the current structure, to embed 'best practice' in the originator should a public securitisation be the ultimate aim and also to encourage investors to participate. The process of providing information on the assets to investors and related reporting requirements may be new to the originator and a private transaction may therefore provide a flexible environment to perfect reporting requirements and processes through discussion with a small number of investors.

Unlisted – but capable of listing. This will depend on the requirements of the investors and how liquid their investment is required to be. Equally, the location of any listing may often not be one of the core markets, but perhaps one with a less onerous listing regime.

Preplaced – the transaction will be structured and written with certain investors and counterparties (such as trustees and swap providers) engaged at the outset, enabling mutually agreeable terms and minimising costly execution risk.

Revolving – "Revolving" in the context of private revolving securitisations means that the revenue generated by speciality finance assets in the portfolio that repay during a pre-determined period (the Revolving Period) may be used to finance the origination of or purchase of new assets (as opposed to being used to repay the funding).

Speciality Finance granularity – Given the nature of speciality finance assets, these are often assets for which no developed securitisation market exists and hence there is no established set of eligibility criteria or asset warranties to be given by an originator in respect of the assets. A private revolving securitisation allows for eligibility criteria, underwriting criteria and asset representations and undertakings to be negotiated on a more bespoke format, which (i) suits the relevant originator's operational standards and (ii) the investors desired credit profile.

Challenges

Given the bespoke nature of private revolving securitisations and the ability to depart from public securitisations in respect of some structural features, transactions may be subject to detailed negotiation between investors and the originator (who is ultimately the borrower of the funding). Key points that will need to be decided between investors and the originator include originator reporting requirements, Revolving Period end triggers, operational flexibility with regard to the servicing of the assets, events of default, eligibility criteria and warranty package in respect of the assets.

Some of these touch points will arise in more traditional conventional speciality finance facilities, though the limited recourse to the originator present in a private revolving securitisation means they will receive more detailed focus from investors.

Though private revolving securitisations may be more simple in structure (including capital structure) than a full public securitisation, this does not mean that the various areas of regulation relevant to the securitisation market can be disregarded. Indeed, a typical private revolving securitisation will include features (such as tranching) that mean materially, if not all, the same regulatory considerations will apply, that apply to a full public securitisation.

However, the commercial dynamic in a private revolving securitisation (including the small number of investors) may provide a setting where discussions can occur about how optimally the transaction can be structured to ensure compliance with relevant regulations. For example, as regards the implications of the forthcoming Securitisation Regulation, investors may not require such private revolving securitisations to be determined to be a simple, transparent and standardised (STS) transactions (and this may not be possible in any event, noting the types of assets that are typically described as speciality finance), but the differing risk retention and disclosure requirements brought about by the Securitisation Regulation would be relevant to originators using this financing technique.

Therefore, care should be taken in structuring any private revolving securitisation, to be implemented prior to the coming into effect of the Securitisation Regulation, to ensure it is implemented in a way that means the grandfathering rules that apply in respect of the Securitisation Regulation are fulfilled (or else the relevant originator is aware of (and comfortable with) the requirements of the Securitisation Regulation that will apply to the transaction in due course).

Market Commentary

We are seeing increased interest in private revolving securitisation structures from both issuers and investors. Issuers can benefit by diversifying and optimising their sources of funding, while investors typically focused on public ABS issuance can achieve improved yields and greater transaction flow.

The similarities of a private revolving securitisation to both a public ABS transaction and a private "pre-public securitisation" warehouse facility mean that notes can be issued to both conduit (or conduit-style) lenders and asset managers. However, asset managers are generally more limited in the extent to which the facility provided to borrowers can be revolving: rather than providing a commitment, below which the facility can be freely drawn and repaid throughout the life of the transaction (as is typically the case in respect of conduit (or conduit-style) lenders) the asset manager's commitment would be fully drawn as a note at closing, with the borrower able to use excess cash during the revolving period to acquire new assets. The funding provided by the asset managers would typically only be repaid on maturity or the transaction moving into a stressed scenario.

Many investors are comfortable with unrated structures, which means that a private securitisation can be issued for traditional ABS asset classes and also non-traditional asset classes such as bridging loans.

By structuring a private securitisation in line with ABS principles, albeit with certain simplifications to improve efficiency as outlined in this article, pricing of private securitisation notes can be anchored to ABS markets, subject to an adjustment for an illiquidity premium. This enables issuers to benefit from spreads being at relatively low levels compared to the past few years.

We therefore see a private securitisation being an option that merits consideration by potential issuers in a range of scenarios:

- To fund a loan book below the c.£150m+ size required for a public transaction
- Where a subset of the loan book is more challenging to securitise publicly due to a requirement for more bespoke investor analysis, e.g. limited performance history
- For assets where there is not yet a developed rating methodology
- To access capital from funders that can only lend in note format, which may not fit with existing bank facilities

EY has significant experience in raising private asset-backed financing and we would be pleased to speak to investors interested in this space and issuers contemplating this type of financing structure.

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What are the differentiators as between a public securitisation and a private revolving securitisation?

In the below table, we look at some of the key differences between a full public securitisation and a private revolving securitisation.

	FULL PUBLIC SECURITISATION	PRIVATE REVOLVING SECURITISATION
Issuer SPV	Typically an "orphan SPV" structure where the share capital of the issuer is held by a share trustee on discretionary trust	Orphan SPV may be used but it is also common for the issuing SPV to be part of the originator's group
Type of structure	Stand-alone or programmatic structures (such as master trust) allowing for multiple issuances	Stand-alone with the ability to add additional investors
Credit Ratings	Publicly rated	If no public rating, may be internally structured using models based on rating agency guidance
Capital Structure	May be complex with a number of classes and excess spread potentially packaged into residual certificates	Senior funding provided by the investors up to an agreed advance rate with remainder of funding provided by originator (though a mezzanine tranche may be included) May include ability for senior tranche to be "re-tranched" into senior and mezzanine tranches
Form of funding	Listed and Cleared Notes and Residual Certificates Bond Trustee and Principal Paying Agents typically required	Variable Funding Note (VFN) that is in registered definitive form or RCF if senior funding is in loan form Issuer SPV may make payments directly to investors
Ability for investors to increase funding	Unusual. Investors typically fully drawn on closing without ability to increase funding (e.g. through a partly paid note structure)	Typically includes ability to increase investor commitment limit (in some cases without investor consent up to an agreed limit) Partly paid note structures may be used
Revolving Period and Repayment Profile	Typically Revolving Period only used for short term assets such as auto-finance contracts Committed run-off structure from close or after Revolving Period (to the extent included) During Revolving Period eligible assets may be acquired by the Issuer SPV from the originator on each Interest Payment Date or intra-period	Typically included for all assets as designed to provide on-going funding for the originator Investors will be committed for a period where funding provided can be repaid and subsequently re-drawn Acquisition method used during Revolving Period may be adjusted to reflect originator systems

	FULL PUBLIC SECURITISATION	PRIVATE REVOLVING SECURITISATION
Servicing Arrangements	Operational risk to be managed in accordance with rating agency criteria Back up servicer and Back-up servicer facilitator mechanics may be used Standard covenants in respect of originator role as servicer	Operational risk to be managed in accordance with discussions between investors and originator Back-up servicer may be used May include more bespoke covenant protection in respect of originator role as servicer
Cash Management	Cash manager may be originator or third party Cash flow strictly controlled, payments waterfalls used to apply cash on each Interest Payment Date	Cash manager typically third party Cash flow strictly controlled, payments waterfalls used May include more flexibility for cash to be used intra-period
Security Package	Security over assets and issuer accounts Security package relatively established for differing asset classes	Security over assets and issuer accounts May include more bespoke security arrangements in respect of the assets depending on the uniqueness of the asset class
Warranty Package/ Eligibility Criteria in respect of the assets	Warranty package relatively established for differing asset classes	May include more bespoke asset warranties/eligibility criteria in respect of the assets depending on the uniqueness of the asset class
Modifications	Strict criteria apply as to when and how modifications can occur to a transaction post-close	Often allows modifications to occur on a more flexible basis (given small number of investors)
Investor Reporting	Standardised in accordance with regulatory requirements	More bespoke depending on the status of originator (e.g. level of historic performance data) and nature of assets

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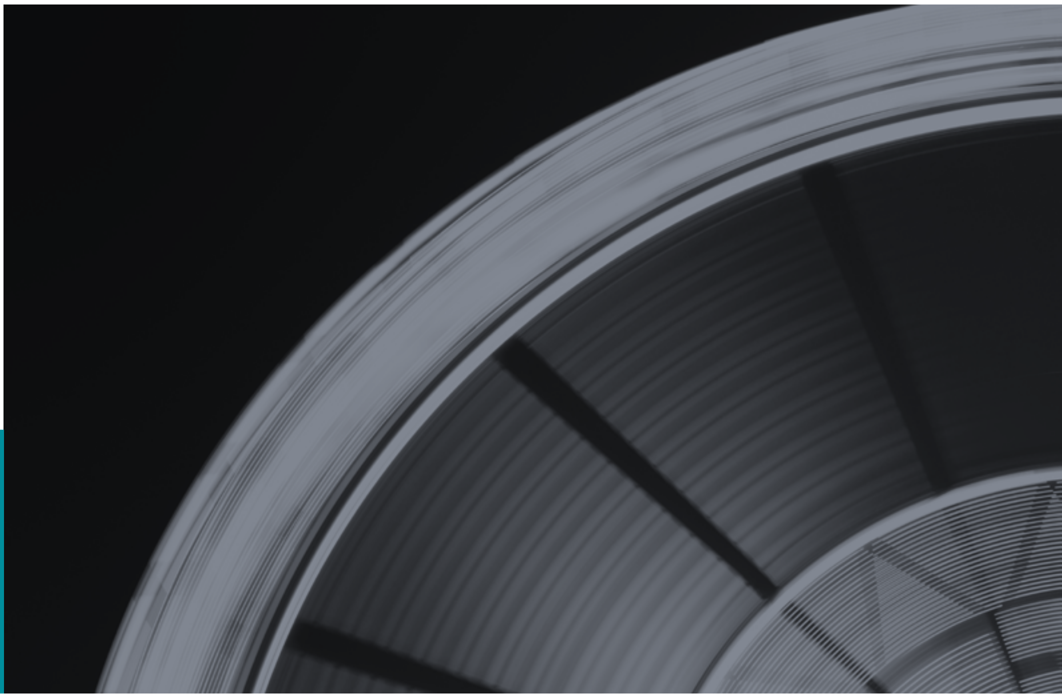

Selected experience of our team

SPECIALITY FINANCE AND FORWARD FLOW

BUY TO LET LENDER

Acting for the funder in relation to a forward flow agreement and associated equity investment in a buy to let mortgage lender

VEHICLE FINANCE COMPANY

Acting for the lenders in relation to their funding of a car, motorbike and van finance company

NORTON FINANCE

Advising the lender on its funding to first and second mortgage lending provider Norton Finance

MONEYBARN

Advising Octopus Investments on its funding to motor finance company Moneybarn

SECURITISATION

A EUROPEAN CAPTIVE FINANCE PROVIDER

on the establishment of its private securitisation platform to fund hire purchase and PCP receivables

THE CONDUIT FUNDER

on a rated warehouse of hire purchase receivables originated by a UK start up auto finance provider

A UK FINANCIAL INSTITUTION

on a private revolving securitisation in respect of its auto leasing and insurance premium financing businesses

A EUROPEAN INVESTMENT BANK

as lender in a private securitisation of non-auto UK hire purchase receivables for a household goods retailer

A US HEDGE FUND AS EQUITY INVESTOR

in a private securitisation funding peer to peer loans originated by a major European P2P lender

A EUROPEAN INVESTMENT BANK

on a private revolving securitisation to fund mortgage originations provided to a UK non-bank mortgage lender ashurst