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UK securitisation and structured finance: review of 2007

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In the UK securitisation and structured finance market, the defining event of 2007 was the credit crisis which developed during the course of the summer and continued to the end of the year and beyond.

Prior to the events of Summer 2007, the markets continued the record-breaking trend that had been set in 2006, with issuance volumes at historic highs across all sectors. The credit crisis manifested itself in a dramatic falling away of investor confidence in the second half of the year, with a resultant loss of primary and secondary market liquidity and a downturn in issuance volumes.

Despite the difficult market conditions, a number of notable transactions emerged during the course of the year, including the development of new structures and asset types. This chapter provides an overview of developments in the securitisation, collateralised debt obligation (CDO) and structured credit products segments of the market, focusing on particularly significant structural developments, and reviews the major tax and regulatory developments that are relevant to these market segments.

Securitisation and covered bonds

Securitisation

As in all areas of the market, 2007 was a tale of two halves for securitisation in the United Kingdom. Record issuance volumes across almost all asset classes in the first half of the year were followed by large volume declines from August 2007 onwards. The second half of the year saw the significant backing up of transactions, with deals commenced and then postponed while issuers first waited for a tightening of spreads and then, when this failed to materialise, considered alternative sources of funding. There was a large

increase in privately placed transactions and in issuers retaining securitisation notes for use as collateral in repo financing with central banks. The performance of existing securitisation structures generally remained stable, suggesting that reduced issuance and increased spreads were driven by the credit crisis rather than fundamental credit quality considerations, although these will become more of a factor if the predicted economic downturn materialises. The exception to this was the sub-prime contagion factor, with negative market sentiment for securitisation structures spreading across all jurisdictions (including the United Kingdom) due to securitisation's association with the sub-prime mortgage crisis in the United States.

Residential mortgage-backed securities (RMBS) continued to dominate the UK securitisation market, with new issuance activity increasing by 3 per cent year on year in 2007. This was mainly due to a doubling in prime RMBS issuance in the first half of 2007, compared to the first half of 2006, and occurred despite a dramatic fall in issuance in the second half of 2007. The number of master trusts increased to 11 with the addition of Pendeford (Birmingham Midshires) and Lanark (Clydesdale Bank). Non-conforming RMBS activity increased by 18 per cent year on year, but fell in the second half of 2007 due to the credit crisis, continuing interest rate rises and weaker house price movements reducing re-mortgaging activities and therefore origination. Interest rate volatility (in particular, the widening of the gap between the Bank of England base rate and the London interbank offered rate) led to the downgrade of three (unhedged) non-conforming transactions, but generally collateral performance remained stable in 2007.

Commercial property investment activity decreased sharply in the United Kingdom in 2007 due to rising interest rates and softening yields. This, coupled with the credit crisis in the second half of the year, resulted in a significant fall in commercial mortgage-backed securities issuance (down 57 per cent).

Elsewhere, 2007 saw the first corporate securitisation (a tap from Punch Taverns) to achieve a AAA rating without the use of a monoline insurer. This

may prove significant given the perceived instability of the monolines during late 2007 and so far in 2008, which played a role in the decline in securitisation issuance among asset classes traditionally wrapped by monoline insurers. Credit card-backed issuance again slowed significantly due to performance volatility. No new asset classes emerged in 2007 but there was an increase in insurance-linked securitisation and small and medium-sized enterprise (SME) transactions and continuing interest in market value securitisation, although no transactions as yet.

Going forward, once liquidity returns to more normal conditions (which may not be for some time), it is likely that investors will look towards higher-quality collateral in lower-leveraged and less complex transaction structures that provide greater transparency. If the projected economic slowdown in the UK economy materialises, the sustainability of previously strong collateral performance in the United Kingdom could be tested during the remainder of 2008 and beyond, presenting a further stress for new and existing securitisation issuance. A desire for increased originator accountability may also lead to a shift away from traditional securitisation structures (particularly RMBS) towards on-balance sheet structures, such as covered bonds.

Covered bonds

Although affected by the credit crisis in the second half of the year, covered bond issuance increased in 2007 with the development of internationally marketed transactions such as the \$3 billion, 10-year maturity issuance by HBOS.

Formal UK-recognised covered bond legislation, which had been expected in 2007, was finally passed on March 6 2008 in the form of the Regulated Covered Bonds Regulations 2008. These establish a legal and regulatory framework for the issue of covered bonds compliant with the EU UCITS Directive in the United Kingdom, enabling certain institutional investors to take advantage of more favourable regulatory capital rules and higher prudential investment limits compared with

investments in non-UCITS-compliant covered bonds. The attractiveness of covered bonds to investors may also be increased due to the perception of greater accountability from, and recourse to, originating entities (one of the criticisms of securitisation structures that has been highlighted during the credit crisis is the lack of accountability of originating entities that transfer assets with only very limited recourse to orphan special purpose vehicles). These factors, together with the desire of financial institutions to diversify their funding sources following the credit crisis, point towards a growth in covered bond issuance volume and an increase in the number of issuers in 2008.

CDOs

In the CDO sector of the market, 2007 saw record collateralised loan obligation (CLO) issuances, although the majority of transactions closed before August 2007 reflecting the market downturn which began in the summer. The average transaction size of CLOs increased and structures became more aggressive, with increased leveraged, tighter spreads on loans and complex currency hedging strategies.

The main structural innovation was the continued development of the *pro rata* CLO structure in which the issuing vehicle can acquire tranches of revolving and delayed draw loans by funding itself through the issuance of senior revolving notes that allow it to call on further advances from the holder of the revolving notes if certain conditions precedent are met.

In 2007 there was only modest growth in the issuance of CDOs of asset-backed securities despite the intense market interest at the beginning of the year, particularly in commercial real estate CDOs. Ultimately, only a very small number of European commercial real estate CDOs have been issued and it was the asset-backed securities CDO segment of the market that was the most dramatically affected by the credit crisis.

Another sector of the market that suffered particularly in the credit crisis was the market for structured investment vehicles (SIVs). SIVs are a form of off-balance sheet financing in which a special purpose

vehicle company acquires highly rated debt securities and funds itself by issuing senior debt and capital. The debt is usually commercial paper and medium-term notes and the capital is usually in the form of subordinated capital notes. A SIV makes a return from the spread between the yield on its mainly long term asset portfolio and its funding costs in the short-term capital markets. SIVs began to experience difficulties during the course of 2007 because of lack of liquidity in the asset-backed commercial paper market. The lack of availability of short-term commercial paper led SIV investment managers to seek alternative funding – including a combination of liquidity facilities and term finance with banks and other financial institutions, repo facilities and selling assets to cover liabilities as they mature.

Synthetic issuance in 2007 was concentrated on managed investment grade transactions and the development of such highly structured transaction types as leveraged super senior CDOs, constant proportion debt obligations (CPDOs) and constant proportion portfolio insurance (CPPI) products.

There was also an increase of interest in the establishment of credit derivative product companies (CDPCs). In some respects these are structured similarly to SIVs, but the operational model and purpose of such vehicles are quite different. A CPDC is an operating company that is established primarily to sell credit protection to counterparties that require such protection from a highly rated provider which funds itself through the issuance of equity and subordinated notes.

Finally, 2007 saw a continuation of the strong trend in the issuance of large-scale balance-sheet synthetic CDOs by banks seeking regulatory capital relief in advance of the implementation of the Basel II accord for banks using the internal ratings based approach. The use of synthetic CDO technology was particularly powerful in the context of underlying portfolios of assets that would not be suitable for conventional true sale securitisations due to their granularity and large size, confidentiality issues or issues relating to transferability. Most of these deals involved corporate or SME loans but there was also some activity with more exotic asset

classes including emerging market loans, insurance assets and project finance loans. Notwithstanding the credit crisis, transactions of this kind continued to be executed throughout the year in both funded and unfunded format.

Structured credit products

In the structured credit products area, 2007 was notable for the prominent role played by highly leveraged market risk products – their rapid growth in the first part of the year and their significant decline in popularity in the second half. Among the most affected by the sudden shift in sentiment were leveraged super senior CDOs and CPDOs, credit products at opposite ends of the capital structure.

Leveraged super senior CDOs

Prior to 2007 much of the considerable growth in the synthetic CDO market was driven by the popularity of mezzanine tranches of leveraged portfolios of corporate credit risk. At a time when more conventional securities such as corporate bonds were offering relatively low returns, mezzanine tranches of synthetic CDOs promised an attractive combination of better returns coupled with investment grade ratings. The other parts of the capital structure, such as the super senior and first loss tranches, were generally unplaced. However, as demand for mezzanine tranches increased, mezzanine spreads contracted, which resulted in investors looking for yield in other parts of the capital structure. The first manifestation of this trend was the repackaging of super senior tranches into leveraged super senior CDOs.

Historically, super senior tranches of CDOs were seen as low-risk, low-return investments, placed (if at all) with only a limited range of investors, such as monoline insurers attracted by the favourable regulatory capital treatment that can be obtained in respect of them. In order to increase the return to investors and enable dealers to sell the super senior tranche, leverage was added to the structure. This led to a product that provided investors with leveraged exposure to market credit spreads rather than to credit

exposure in the traditional sense. The terms of the notes typically build in market value triggers to identify when the notes have suffered significant market losses and, if certain spread thresholds are breached, the investor is given a choice of either providing additional collateral or allowing the notes to be redeemed early at their market value.

Volatility in credit markets in the second half of 2007 led to some of these spread thresholds being breached, with a consequent downturn in the issuance of leveraged super senior products. However, managed structures fared better, with some asset managers able actively to manage the portfolio so as to avoid the need to unwind or collateralise the structure.

CPDOs

The first part of 2007 also witnessed significant activity at the opposite end of the capital structure, the equity tranche. Arranging banks developed a number of new products that aimed to repackage first loss risk and perhaps the most prominent of these was the CPDO.

In a CPDO, a special purpose vehicle (SPV) issues notes, the proceeds of which are invested in non-risky assets – usually cash or highly rated collateral securities. The SPV concurrently enters into a total return swap with a swap counterparty under which the SPV is exposed to the risk of a leveraged portfolio comprising widely traded investment grade credit indices such as iTraxx and CDX. Arrangers have also structured CPDO transactions referencing bespoke managed reference portfolios of corporate names. The degree to which the reference portfolio is leveraged can change at any time depending on the difference (typically referred to as the 'shortfall') between the present value of all of the SPV's future liabilities (including interest, principal and any fees) and the net asset value of all the assets held by the special purpose vehicle. The SPV has two main assets – the mark-to-market value of the portfolio referenced in the total return swap and the deposit of cash or collateral securities held by the SPV. The value of the deposit will increase as credit premia are paid to the SPV and as trading gains are realised in respect of the portfolio, and

will decrease as trading losses are realised in respect of the portfolio and as fees and any credit event settlement amounts are paid by the SPV. If the shortfall decreases, this will mean that the portfolio is performing well and if it is reduced to zero – a 'cash-in' event – the swap is unwound and the notes convert into a risk-free investment that simply pays the stated coupon plus par on maturity. However, if the net asset value of the SPV's assets falls below a minimum percentage of the principal amount of the notes (usually 10 per cent), the structure is subjected to a forced unwind – a 'cash-out' event.

In the first half of 2007 the issuance volumes of CPDOs grew considerably, a trend that was based in part on the ability of the product to offer AAA-rated notes paying a coupon considerably higher than other similarly rated structured products. However, CPDOs were badly hit by the difficulties in credit markets that began in August 2007 and a higher-than-expected number of transactions have cashed out as a result of significant increases in market credit spreads. This has led to a steep decline in the issuance of CPDOs and investors have called into question the financial models that banks and rating agencies developed to structure and rate these transactions. However, as with leveraged super senior structures, managed CPDOs have performed better than static structures. With investors looking for effective ways to navigate volatile credit markets, it is likely that managed credit products will generally become more popular in 2008.

Tax developments

Securitisation company regime

In 2007 the UK securitisation company regime came into force, following many months (if not years) of discussions between the Treasury, HM Revenue & Customs and the securitisation industry.

The regime was designed to encourage the use of UK SPVs for securitisations and to address concerns in relation to the introduction of IFRS accounting. The new rules have significantly simplified the tax treatment of SPVs to which they apply – broadly speaking, as long as certain conditions are satisfied,

they are simply taxed on their retained cash profit, which can be a nominal amount.

While some professional advisers have been promoting the use of UK securitisation companies, it is fair to say that they have not yet achieved a great deal of traction, other than in cash securitisations of UK assets such as UK mortgages or UK real estate where the use of a UK issuer is, and always has been, necessary from a UK withholding tax or capital gains perspective. Prior to the 2008 Budget announcements, UK stamp duty issues remained a material obstacle to issuing notes out of a UK issuer. Perhaps the main example of this was that UK-issued limited recourse notes are currently potentially subject to UK stamp duty because their limited recourse nature may be viewed as making their interest results dependent. The chancellor announced in the 2008 Budget that this one remaining technical hurdle will be removed by legislation to be introduced in the Finance Act (likely to take effect in July 2008). This change has been introduced with the UK securitisation company regime very much in mind – that is, in practice it is intended to exempt notes issued by a UK securitisation company from UK stamp duty and avert the recently emerging trend of incorporating UK securitisation companies in Jersey, but making them UK tax resident by locating their boards in the United Kingdom. In particular, it should make it easier for UK incorporated securitisation companies to issue limited recourse notes.

Whether this alone will be sufficient to increase dramatically the take-up of UK securitisation companies is doubtful. However, more UK securitisation companies are likely to be used over the next 12 months, as the market becomes more comfortable with the concepts and structures. For the time being, the well-trodden path of locating issuers in the Netherlands, Ireland, Luxembourg, Jersey, the Cayman Islands and similar jurisdictions remains more common, particularly for synthetic deals.

Sukuk

Since 2005, every year the UK government has taken steps to boost the Islamic finance market in the United

Kingdom and underline the United Kingdom's dominant position in the European financial markets. One of these steps has been to ensure that the UK tax rules work correctly in the context of Islamic finance – for example, taxing the return on a *sukuk* as though it were interest while recognising that it is not. In 2007 a number of further measures were announced in this area in both the Budget and the Pre-Budget Report.

The government also stated in the 2008 Budget that while any final announcement would be premature, it continues to examine the feasibility of a sovereign *sukuk* issuance and will take powers to facilitate such an issuance, including the power to amend existing legislation on alternative finance arrangements, such as alternative finance investment bonds (as debt like *sukuk* is known in the UK tax legislation).

Changes to the investment manager exemption

The HM Revenue & Customs Statement of Practice setting out the scope of the UK investment manager exemption was re-issued in 2007 after much discussion with industry representatives. The investment manager exemption allows UK investment and portfolio managers to act on behalf of non-UK SPVs and funds without subjecting them to UK tax provided that certain detailed conditions are met. Similarly, the 2008 Budget announced some minor legislative changes to broaden the UK investment manager exemption.

The changes were broadly welcomed as they clarified and extended the scope of the asset classes UK investment and portfolio managers can deal in without fear of bringing their clients within the UK tax net. However, one less positive development relates to the requirement that the UK manager earns an arm's-length fee. HM Revenue & Customs' recent shift of emphasis to the manager's net profit position (eg, after paying out any sub-advisory fees) has meant that sub-advisory relationships between a manager and its affiliates, of which the client might not always be aware, potentially have an impact on the client's entitlement to the investment manager exemption.

Regulatory developments

In 2007 the EU Transparency Directive and the EU Markets in Financial Instruments Directive (MiFID) were implemented, and the impact of the market abuse regime provided for by the EU Market Abuse Directive continued to be felt.

The aim of the Transparency Directive is to encourage a pan-European market through the provision of minimum disclosure requirements for issuers with securities that are admitted to trading on a regulated market in the European Union. The Transparency Directive has been implemented in the United Kingdom, Ireland and Luxembourg, and therefore applies to all issuers with securities admitted to trading in the regulated markets in those jurisdictions. Essentially, the directive harmonises the continuing obligations of issuers of listed securities and imposes an obligation to produce an annual and half-yearly financial report including accounts in accordance with IFRS or equivalent. Third country issuers, therefore, need to produce IFRS accounts unless the accounting standards used by them are deemed to be equivalent to International Financial Reporting Standards. There are certain transitional provisions for issuers reporting in accordance with US, Japanese and Canadian GAAP and the European Commission is looking at other jurisdictions. Issuers whose only securities admitted to trading on an EU regulated market have denominations of over €50,000 are exempt from these periodic reporting requirements. However, the directive can still be problematic for issuers which currently do not produce accounts at all (eg, Cayman issuers) if they have securities which are admitted to trading with lower denominations. Options for such issuers include:

- redenominating the affected securities;
- moving the securities to the exchange-regulated markets (eg, the Professional Securities Market in London, the Alternative Securities Market in Ireland or the EURO MTF in Luxembourg); or
- listing outside the European Union.

MiFID came into effect on November 1 2007 in a number of member states (including the United Kingdom). MiFID aims to harmonise the regulation of investment firms across the European Union, in particular in relation to the conduct of business rules. While the EU Prospectus and Transparency Directives which essentially govern the offering and sale of securities, MiFID does contain a number of provisions which have an indirect effect on securitisation and other structured finance transactions (eg, in the context of financial promotion, inducements and client categorisation). In particular, there is some discussion at the International Capital Markets Association as to whether to amend the current recommended form of selling restrictions to reflect changes to the financial promotion regime in relation to authorised persons. In addition, MiFID contains provisions on inducements which, as well as requiring an authorised firm to "act honestly, fairly and professionally in accordance with the best interests of its client" when providing investment and/or ancillary services, prohibit the payment of fees or commissions (eg, underwriting fees, swap spreads and any distribution fees) other than in specifically permitted circumstances. There is ongoing discussion as to whether and how such inducements are communicated to investors. Finally, the client categorisations have changed so that there is a new regime consisting of retail, professional and eligible counterparties and documentation (eg, custody and portfolio management agreements) will need to reflect these changes. In addition, portfolio management and other transactional agreements generally will need to reflect the new obligations which MiFID imposes on authorised firms to comply with the new conduct of business rules.

The EU Market Abuse Directive was implemented on July 1 2005 and in December 2006 the European Securitisation Forum published market guidelines in relation to the application of the directive to the

securitisation market. Under the directive, issuers of securities (including asset-backed securities) which are admitted to trading on an EU regulated market are obliged to disclose certain inside information to the market. Although the obligation is on the issuer to comply with the obligations, the practical questions of who should be able to assess and disclose inside information, how such information should be made and how it should be documented remain problematic. In light of current market events (including rating downgrades), careful consideration needs to be given to compliance with these obligations.

Conclusion

At the beginning of 2008 the outlook for the UK securitisation and structured finance market remains uncertain. Reduced investor demand resulting from the transparency and accountability issues that were central causes of the credit crisis in the first place and the accompanying mark-to-market volatility to which the sector is now subject have led to much reduced issuance volumes. It is difficult to make any firm prediction as to how and when the market will revive. However, particular sections of the market appear to be less affected than others. For example, on the cash side of the market there appears to be scope for large-scale balance sheet securitisations and CDOs and for covered bond transactions. On the synthetic side, interest in loan credit default swap transactions and credit derivative product companies (to mention just a couple of structures) is robust. The business rationale for securitisation and structured products generally remains strong and the finance industry's capacity for innovation has been well demonstrated in the past. The coming months promise to be interesting indeed.

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