SIMPLE SECURITY

Securitisation is no longer the preserve of big banks and there is now ample opportunity for smaller commercial players to get involved in this lucrative funding option. Richard Senior, managing director of Robin Hood Finance, investigates.

The NACFB was set up to promote the interests of both members and their customers. One aspect of this is helping to ensure that the customer gets best value, regarding both terms and transparency. As Keith Heron puts it: "We want to ensure the consumer gets the best possible deal, and if the smaller niche players are able to secure cheaper funds they will be more competitive and consumers will have greater choice".

This article looks briefly at how things are done at present, then examines an alternative business model using direct access to the international capital markets.

A broker's role is clear: it is to find the best deal for the customer. In return, the broker receives commission, and the lender receives fees (in some cases), and interest over the life of the loan.

It is interesting to look at how the value in such an arrangement is distributed. Let's assume a five-year £100,000 buy-to-let loan. The broker may receive 0.5% commission, which is equivalent to 0.1% p.a. over 5 years (ignoring time value of money). The lender receives, say, Libor plus 1% p.a. This looks like ten times as much as the broker, but the lender is of course responsible for loan administration, and has capital and funding to find. Lenders may also suffer credit losses and loss of income from early repayments. Nonetheless, it is profitable business, and the lender has recurring income, unlike the broker.

If there were a way of getting cheaper funding, and reducing the need for capital, wouldn't that mean a better deal for everybody? I've been active in securitisation since 1989, and I think it has much to offer in this regard.

Securitisation turns pools of illiquid assets into highly liquid bonds, which then trade at low levels relative to Libor: a very attractive source of funds. This funding market is huge, deep and growing: in 2004, £170 billion was issued in Europe, over half of which was mortgage-related. The figure for the USA was even higher, at £500 billion.

The basic principle of securitisation is to create pools of standardised loans, which are then reviewed by rating agencies. There are three of these: Moody's, Standard and Poor's, and Fitch. They award ratings ranging from AAA (best) to D (defaulted). A typical loan securitisation will have various series or tranches, ranging from AAA to BB. For residential mortgages, 90% or so is rated AAA. A rating is seen by investors as an objective appraisal of all the risks involved. With a rating, bonds can be sold to investors worldwide.

AAA residential mortgage bonds currently trade at Libor plus eight to nine basis points (0.08-.09%). AAs and BBBs trade at 15 and 50bp respectively. Of three buy-to-let securitisations I recently looked at, weighted average margin (WAM), which is the cost taking into account the various tranche sizes, was between 16 and 30 basis points. A securitisation of commercial mortgage-backed loans had a WAM of 40bp. That's attractive funding in itself, but there's an additional benefit when we look at capital requirements.

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Because securitisation is largely driven by economics and not regulators, much less capital is needed. Of the three securitisations involving buy-to-let, retained risk (i.e. capital) ranges from 0.5% to 1.9%. That's a good deal less than the 8% which a bank has to set aside for conventional, balance sheet funding (mort-

gages are currently 4%, falling to 3.5% under the new Basel II banking rules). In addition, you can't lose more than the retained risk whatever happens, which is not the case with conventional bank lending.

Securitisation is attractive to the big players: HBOS securitised £14bn of mortgages in 2004. At the other end of the scale, I am currently mandated on the refinancing via securitisation of a factoring book in an amount of £50 million, which is perfectly feasible. The market is moving rapidly, and securitisation is no longer the preserve of big banks.

Another application at the smaller end of the scale is trade receivables securitisation. This is related to factoring and invoice discounting, but produces short-term notes with a rating, which again means direct access to the capital markets and so cheaper funding. For many years this was only done for books of over £50 million, but I am advising a German company which will be doing deals from funded amounts of £5 million upwards on this basis. Several deals under £10 million funded were completed in Europe in 2004. It is significantly cheaper than factoring.

The main point is that it is possible to get cheap funding directly from the capital markets for most types of business. I feel confident in saying that if you can show me a steady flow of standardised business, I can show you how to fund in the capital markets. This can be for existing books, or new products can be created which have been designed to be rated and securitised. A small warehousing line is usually required, but much smaller than the eventual amount funded. This approach is excellent for standardised products. It is complementary to, rather than directly competitive with, existing offerings. I have, for example, recently been looking at a new buy-to-let product, to be funded via securitisation, which would in certain cases give higher LTVs than current products.

A potential benefit for brokers is that, since the funding cost is likely to be significantly lower under securitisation, some of the cost savings could be passed on not only to the customer but also to the broker. This could take the form of annual commissions in addition to the normal commission. The presence of a regular income flow would also increase the value of a broker's business.

Securitisation can certainly meet the test put to me by Keith Heron quoted at the start of this article. I have concentrated on the potential benefits of funding in international capital markets, and avoided discussing the technical aspects of how securitisations are put together: that would take up a separate article or even series of articles. As a final word, after 16 years in the securitisation business, I can certainly say: "It's simple...but it's not easy". **NCF**