GETTING THE MOST OUT OF ABCP

PERMJIT SINGH EXPLORES THE BACKGROUND TO AND HIGHLIGHTS THE BENEFITS AND PRACTICAL ISSUES FROM A TREASURY VIEWPOINT OF USING ASSET-BACKED COMMERCIAL PAPER TO FINANCE A COMPANY'S ASSETS.

In this article I have two objectives: to highlight the benefits to a company of using asset-backed commercial paper (ABCP) as a source of funds, and to highlight my personal observations of the issues a treasurer should be aware of when managing a project to establish an infrastructure to support ABCP. If I achieve both, I hope treasurers will be better-positioned to take advantage of ABCP to finance their company's assets. As with other forms of structured finance, ABCP is complex and requires considerable investment upfront of time and money before funds flow into the company; but its advantages in terms of funding cost, transparency, flexibility, and diversity can outweigh these disadvantages.

The article will be structured as follows: I will first define ABCP, describe the largest ABCP market and its size in relation to the larger market for commercial paper (CP), discuss the advantages of ABCP as a source of funds, and provide a simple illustration of how ABCP is issued and the inter-relationship between the entities involved. I shall also consider upfront and continuing costs of using ABCP, including the costs of credit enhancement and the fees payable to the parties involved. The second part of the article will focus on the practical issues a treasurer should be aware of when managing a project to establish an effective infrastructure to support the issuance of ABCP. Key among these issues are: a term sheet agreed by the various parties which defines the company's objectives; technology to monitor assets; and the co-operation of the company's board of directors, various internal departments, and third parties: the bank that issues ABCP, the credit rating agencies and the law firms.

☐ OVERVIEW OF ABCP.

CP is a short-term unsecured debt security which a company issues to an investor, usually via a dealer, in exchange for cash. As its name suggests, ABCP is CP which is secured (backed) by assets. The largest market for ABCP is the US, totalling $727bn in February 2002 and representing about 51% of the total US CP market, according to CSFB.

ADVANTAGES OF ABCP
▪ Reliable
▪ Flexible
▪ Lower cost of debt
▪ Greater transparency of assets
▪ Enhanced asset management

Companies, unless they have a large asset base to support issuance themselves, usually enter into an agreement with a bank whereby the bank issues ABCP under its ABCP programme on the company's behalf. The bank can offer its programme to multiple companies, each of whom can offer various asset types as collateral for the ABCP – so-called 'multi-seller programmes'. This arrangement overcomes the need for the company to establish a programme itself, however, it will probably need to establish a special purpose vehicle (SPV) company to ring-fence the assets from its other assets, and enter into detailed agreements setting out the terms and conditions under which the company will use the bank's programme.

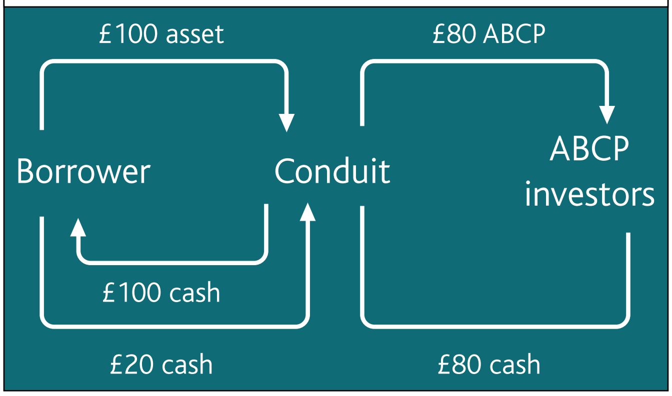
An ABCP programme overlooks the credit status of the company in favour of the credit status of its assets. Therefore, in the absence of any external support, even though a company's credit rating deteriorates, it can still access the ABCP market for finance, and at the same cost, provided its assets' credit quality does not similarly deteriorate. ABCP programmes, therefore, can be a reliable source of finance for companies that experience a downturn in their credit status.

ABCP programmes are also a flexible source of finance: companies may issue as little as $5m to over $100m of ABCP, at a time. This flexibility allows companies whose asset origination volumes are too small for them to access the term securitisation market (where individual transactions are typically in excess of $100m) to still access capital markets investors.

In *Figure 1*, a conduit acquires £100 of assets originated by the company. The conduit pays for these assets by selling an interest in them to the company for £20 and to ABCP investors for £80. The effect of this arrangement is that £80 of the assets originated by the company are financed by ABCP investors and neither this portion of the value of the assets nor the ABCP appear on its balance sheet. However, the remaining £20 portion of the value of the assets does appear on its balance sheet. Also, residual income from the whole of the assets is channelled to the company via its interest in the conduit and appears in the company's profit and loss account. The £80 received by the company can be used by it to repay bank debt and/or to originate further assets - which can also be acquired by the conduit and 80% of which can be financed by ABCP investors.

THE CONDUIT. The conduit is a bankruptcy-remote SPV created by the company whose primary purpose is to hold assets acting as collateral for ABCP investors and for the company. ABCP issued under the bank's programme is passed through to the conduit in exchange for an interest in the assets held by the conduit. The assets held by the conduit provide the sole source of principal and interest to repay ABCP investors and the company. If the assets become non-performing and there are credit losses, the company will be the first in line to absorb such losses - through its interest in the conduit's assets. The company's interest is therefore subordinated to the ABCP investors' interest and hence it interest represents credit enhancement for the bank's programme.

FIGURE 1
ABCP ISSUANCE AND THE INTER-RELATIONSHIPS INVOLVED.



By increasing the transparency of the company's assets through segregating them into a SPV, the company might be able to remove a premium for uncertainty that lenders might otherwise include in their risk-adjusted rate of return, thereby reducing the company's cost of funds.

Detailed information produced periodically by the company about the conduit's assets for the bank providing its ABCP programme, can also be used by the company itself to enhance its asset management generally.

CREDIT ENHANCEMENT. The amount of credit enhancement is related to the nature of the assets. Generally, the higher the credit risk of the assets, the higher the amount of credit enhancement required by the bank. An additional factor is the company's ability to perform under the terms of the programme. To assess this ability, the bank will undertake an extensive due diligence exercise – looking at the company's standards of asset origination and underwriting, and its ability to administer the conduit's assets. The bank might ask the programme's credit rating agencies to quantify the amount of credit enhancement required to achieve a certain rating (eg, long term of AA), which the bank can then use as a guide to the amount of credit enhancement it will require from the company in the form of a subordinated interest in the conduit's assets (so called seller-specific credit enhancement). The actual amount of seller-specific credit enhancement is therefore provided for the benefit of the bank rather than for maintaining the programme's actual credit rating. The programme's credit rating though dependent on a certain amount of seller-specific credit enhancement, also depends upon protection provided by the bank itself – through programme-wide credit enhancement and a liquidity facility.

PROGRAMME COSTS. Upfront costs of entering into the financing arrangement with the bank should be amortised in the company's profit and loss account over the expected life of the arrangement (for example, three years). Upfront costs include: legal fees payable to the law firms for documentation and legal opinions, an arrangement fee payable to the bank which provides the ABCP programme, and rating agency fees for reviewing the documents and for quantifying the level of credit enhancement to maintain a desired rating. In addition, where a trustee, company secretary and directors of the conduit are appointed, an upfront arrangement fee might also be payable for such services. Upfront costs should be included in the periodic calculation of the company's cost of funds of the programme – that is, along with ABCP interest charges and continuing costs.

Continuing costs, which are paid out of the residual income of the assets, include: ABCP dealer fees for issuing the ABCP; a programme fee payable to the bank for administering the programme; FX SWAP costs to convert the ABCP to the currency required by the company; and possibly a non-utilisation fee payable to the bank where the amount of ABCP outstanding is less than the total available under the programme. Where a trustee, company secretary and directors of the conduit are appointed, continuing fees will be payable for such services. The conduit is also likely to pay an administration fee for administration of its assets. However, this cost is not a true cost to the company as it usually undertakes this role itself. Tax advice should be sought to minimise tax leakage from the financing arrangement (for example VAT on the administration fee, withholding tax on interest, and stamp duty or capital gains tax on asset sale or transfer).

☐ PRACTICAL ISSUES.

The treasurer needs to identify and prioritise the company's key reasons for choosing to use an ABCP programme and remain focused on these throughout the negotiation and implementation stages. For example, achieving off-balance sheet treatment might be the main reason, in which case ensure this reason remains top priority in comparison with other less important reasons, such as flexibility over eligible asset types.

PRODUCE A TERM SHEET. A term sheet should incorporate the key reasons for using the ABCP programme and once it has been agreed with the company's parent, auditors, and law firm, only change it to incorporate the terms and conditions required by the bank that is subsequently awarded the mandate. Thereafter, further revisions to it should be avoided as much as possible because otherwise they will lead to delay, frustration, and cost.

INFRASTRUCTURE. Ensure the company has – or will have by the target date to issue ABCP – the systems to comply with the terms and conditions of the programme. Where possible, try to draft the transaction documentation so that it fits around the company's existing infrastructure rather than changing the existing infrastructure to fit around the programme documentation - especially in relation to IT requirements. It is far easier, quicker, and less costly to reword documents than to restructure existing IT technology and other systems. A key ability of the company's infrastructure, especially of its asset database, is to differentiate asset cashflows into principal and revenue. Asset principal is used to pay off ABCP principal and must not, unknowingly, be used to pay ABCP interest or other expenses, otherwise the conduit will have a mismatch between its assets and liabilities on its balance sheet, and its profits figure will be understated.

HUMAN RESOURCE. To establish the infrastructure to manage an ABCP programme, the company will need to allocate dedicated human resource, which is likely to come from its treasury and IT departments. The treasury will act as a co-ordinator or project manager: liaising with the bank, credit rating agencies, lawyers, and internal departments. The IT department will undertake systems developments to ensure they meet the requirements of the programme. On a continuing basis (after the programme is up and running), the company will still need to supply dedicated resource. Again, this is likely to come from the treasury as the programme represents an additional funding source for the treasury to use.

CONCENTRATION LIMITS. As well as being able to monitor assets separately, the company's reporting systems should also be able to track various concentrations of assets where limits are placed on these by the programme documents. For example, in relation to a portfolio of residential mortgage assets that act as collateral, no more than 50% of their total value may relate to mortgages on property located in the South East, or no mortgage may have interest arrears in excess of 60 days. Such concentration limits should be carefully considered by the company when negotiating them and other eligibility criteria with the bank as they will affect the amount of finance the company obtains from the ABCP programme – that is, assets which exceed such limits will not be eligible to be financed by ABCP and will therefore need to be financed in full by the company, and they will also appear in full on the company's balance sheet. As well as enlarging the company's balance sheet, such ineligible assets will increase its on-balance sheet funding requirements, and possibly its cost of funds too.

ELIGIBLE ASSETS. The asset eligibility criteria negotiations with the bank should also take into consideration anticipated changes in the types of assets the company will originate over the life of the programme, and which it intends to also finance with ABCP. For example, the company might intend to originate mortgages that are: second rather than first charges on property; denominated in foreign currency rather than sterling; or are secured over commercial property rather than residential property. If these asset types are already eligible, the company should consider whether the concentration limits for them are sufficiently high to accommodate increased volumes of each type. However, setting concentration limits that are not going to be approached for several months could result in a seller-specific credit enhancement amount being set that is too costly to the company because of the additional credit enhancement it includes, and so an option to increase the concentration limits at a later date might be a cheaper solution. Having the foresight to ensure that the documentation is sufficiently flexible to accommodate asset evolution might save more time and expense than incorporating such flexibility into the documentation at a later date, and possibly at a time when the company's negotiating position has deteriorated.

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BOARD APPROVAL AND INTERNAL CO-OPERATION. The programme's success depends on the extent to which the company's board of directors' asset origination and growth strategy matches the eligibility criteria of the programme. It is therefore essential before embarking on an implementation plan to first obtain the support and approval of the board of directors, and probably the parent company's also. Success also depends upon the co-operation of various departments in the company. For example: the sales and asset underwriting departments need to be aware of the types of assets that are eligible and, when concentration limits are exceeded, to consider originating less of the corresponding asset types to rebalance the asset composition in line with the agreed concentration limits. The IT department needs to develop and maintain systems to administer and report on the assets periodically. The finance department needs to account for the transaction and produce periodic management and statutory financial accounts. The legal department needs to appoint directors, arrange board meetings and resolutions, while the treasury department needs to act as a link between these departments and third parties, monitor compliance with the documentation, and manage the issuance and repayment of ABCP in conjunction with the bank's ABCP administration team.

APPOINT A BANK. A bank can be awarded a mandate to provide its programme by a tender process, whereby a standard pack of documents is sent to each bank that has accepted the invitation to bid for the mandate. The pack should contain the following documents:

- **Covering letter:** explaining why the company is writing to the bank.
- **Questionnaire:** seeking information which the company needs from the bank to assess its bid (the questions will focus on the programme, its performance in terms of interest cost and volume of ABCP outstanding, upfront and continuing costs payable by the company, and whether the programme can accommodate the company's asset types).
- **Term Sheet:** setting out the main terms and conditions of the financing arrangement from the company's perspective. The term sheet will need to be updated subsequently to incorporate the mandated bank's terms and conditions of its programme.
- **Confidentiality Letter:** this is used to ensure that sensitive information exchanged by both the bank and the company is kept

confidential. Beware, this letter can be a potential drag on the speed at which the bank submits its bid if both sides' lawyers become intransigent on the finer points of the letter.
- **Timetable:** to ensure the bank can meet the company's expectations.

SHORTLIST OF BANKS. Of the banks invited to tender, a shortlist should be produced. The selection criteria will usually include the following factors:

- **Pricing:** are the interest costs payable on ABCP computed on a consistent basis (for example, either money market yield or discounted). Are there hidden costs, or costs not included (such as dealer fees or FX SWAP costs). How does each bid compare to the other bids and to the company's other debt sources? Is a bank's interest cost a forecast and if so how does this compare with that bank's actual performance. If the bank's quote appears to be relatively low in terms of costs payable by the company, could the bank be loss-leading to obtain other business (such as a term securitisation mandate). Could the bank try to recover this loss at renewal of the programme?
- **Relationship:** how important is the bank to the company or to its parent? Could the bank offer other services, such as banking services?
- **Ability:** does the bank's programme already include the company's types of assets? If not, will this: delay implementation (because of the extra time required to explain the asset types to the bank's credit committee), increase costs, or lower the value of the programme because the bank has set overly conservative eligibility criteria?
- **Flexibility:** will the bank allow other asset types to be eligible as the company develops (for example, higher risk assets, or more of the current asset types)? How quickly can the bank approve changes to the programme?

APPOINT LAW FIRMS. The choice of law firm might be limited because of parent pressure, or because the firm has an existing relationship with the company which will save time and reduce fees. It is likely that a number of law firms will need to be appointed by the company if the assets are originated in multiple jurisdictions and legal opinions are required of each, such as Northern Ireland and Scotland. Legal fees should be agreed by the company and each law firm in advance of work commencing, and where possible the company should cap the fees – especially if the transaction is uncharted territory and could therefore involve other departments of the law firms (such as trust and tax).

CREDIT RATING AGENCIES. The programme's credit rating agencies should be informed by the mandated bank (in conjunction with the company) of the intention to use the bank's programme to finance the company's assets. The agencies' availability to approve the transaction documents and to quantify the credit enhancement level required to maintain the desired credit rating should be ascertained, in addition to their fees. The company should be aware that it will be competing with other companies for the agencies' time and hence as much notice as possible should be given to the agencies of the company's requirements and timetable.

MANAGE YOUR BANK. The bank will require an upfront arrangement fee for allowing the company to use its ABCP programme, for its time to undertake a due diligence and credit assessment of the company and its assets, and to liaise with the programme's credit rating agencies. The arrangement fee is negotiable but is likely to be £100,000 plus and is payable by the company in addition to the bank's programme fee.

> 'LEGAL FEES SHOULD BE AGREED BY THE COMPANY AND EACH LAW FIRM BEFORE THE WORK COMMENCES, AND WHERE POSSIBLE THE FIRM SHOULD CAP THE FEES, ESPECIALLY IF THE TRANSACTION IS UNCHARTED TERRITORY'

ENGAGEMENT LETTER. Some banks will require such a letter from the company as a condition of the mandate. It sets out the bank's remuneration and the services it will provide, and it may serve as a reference document in case the relationship sours and a claim ensues. Again, beware: each side's lawyers have been known to stall progress because of differences over the wording of this letter.

DUE DILIGENCE. The bank will want to review the company's operations (especially asset origination, underwriting, and administration) and meet with senior managers to discuss the company's development, strategy and organisation. This due diligence is significant to both company and bank as it will influence the bank's internal credit assessment and hence the level of seller-specific credit enhancement it will require from the company. The due diligence can be as short as half a day or extend to several days, and its agenda is set by the bank and the company. Good project management skills can mean the difference between success and failure because the due diligence is likely to be logistically challenging – involving the co-operation of several of the company's departments and its board of directors, each giving presentations, answering detailed questions, and being available at precise times and dates.

BANK RELATIONSHIP. It is important for the company's ABCP programme administration team (most likely the treasury team) to meet and establish a good working relationship with the ABCP programme administration team at the bank as they will be liaising with each other almost on a daily basis to issue and repay ABCP, discuss periodic data about the conduit's assets, and to agree procedural issues where these are not covered in the documentation, or not in sufficient detail. Additional dialogue will arise where the assets are refinanced periodically by the company, for example, by undertaking a term asset securitisation and using the proceeds to repay maturing ABCP.

ASSESSING THE TRUE VALUE OF USING ABCP. Using ABCP as a source of finance for a company's assets has advantages and disadvantages. The benefits of increased flexibility, asset transparency, reliability of funds, and reduced interest costs, should be weighed against the time, resource, and expense required to establish an infrastructure capable of continuously and closely tracking the company's assets.

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