Article Title: ARCHIVE | Criteria | Corporates | Recovery: Analyzing English Secured Loans Data: Asset-backed securitization separates the creditworthiness of the originator from the creditworthiness of its assets. Traditionally, this has been achieved through a sale of the assets by the originator to the issuer ("true sale"), in circumstances that render the sale free from attack in any subsequent insolvency of the originator. For Standard & Poor's rating purposes, this means that the originator's insolvency is unlikely to interfere with the timely payment of interest and the full return of principal on the stated maturity of securities backed by the underlying collateral ("full and timely payment"). Increasingly, issuers have looked to the use of structuring techniques to provide more efficient funding, even in transactions that do not meet the criteria for pure asset-backed finance. They have asked that the rating reflect the enhanced ability of the transaction to repay the rated securities in full, as compared to the issuer credit rating (that is primarily an indication of the likelihood of an issuer's default). Both issuers and investors are mainly interested in focusing on transactions structured as secured loans, used in the context of corporate restructuring or acquisition finance. As structured finance markets mature, investors have shown a willingness to consider transactions that do not fully isolate the underlying collateral from the effects of the originator's insolvency. In place of an effective true sale, such transactions involve a loan to the originator secured by assets belonging to the originator ("secured loan"). From a rating (full and timely payment) perspective such a structure raises many problems. For example, in many jurisdictions local insolvency laws will respect priority conferred by security but will not permit the secured creditor to have full control over the enforcement and realization of security. Such laws may affect the timing of a secured creditor's enforcement of its security by giving power to dispose of secured assets to an officeholder (thus putting full payment at risk), and/or by imposing a stay or moratorium on enforcement (thus putting timely payment at risk). Traditionally, therefore, Standard & Poor's has not rated secured debt significantly higher than unsecured debt of the same originator. This is because, among other things, studies show that the frequency of default of secured debt and of unsecured debt is generally the same and because there is no obvious or certain methodology for sizing liquidity risk flowing from the timing risks inherent in the enforcement of security. With the maturing of the structured finance markets, Standard & Poor's is willing to consider rating secured loan structured financings provided full and timely payment objectives are met. This article examines some of the English legal and structural requirements relevant to secured loan structured financings. The methodology described in this article can be adapted for use in other jurisdictions, depending on local laws. Its use may expand the range of rated transactions that use structuring techniques to mitigate timing and/or ultimate recovery risks. FOUR LEVELS OF REVIEW Standard & Poor's review of any proposed secured loan structured financing will focus on the risks to full and timely payment. There are four levels to this review of "secured loan securities." Status of the originator. Standard & Poor's has concluded that a secured loan security has the greatest chance of achieving a rating that is significantly higher than the rating of the originator if the originator is a single business/single activity entity. Full enforceability of secured loan and security. Standard & Poor's must be comfortable that, as a legal matter, the secured loan transaction and the security in favor of the issuer are fully enforceable and cannot be challenged either under the general law or under insolvency law. True control. Standard & Poor's will review the security package over the originator's assets granted in favor of the issuer. Standard & Poor's must receive comfort that the issuer has "true control" over its security. If the security package is such that the issuer has the conduct of (has control over) the enforcement of its security, the issuer has priority over all competing creditors, and the security is over appropriate assets and is adequate to repay investors, Standard & Poor's can conclude that the issuer has true control over its security. Liquidity support and additional structural requirements. Standard & Poor's will review the liquidity risk in any secured loan structured financing and will usually require liquidity support at a level that mitigates such risk. Standard & Poor's also will review the need for additional structural requirements such as credit enhancement and measures to reduce any "incentive to file" for the insolvency of the issuer or otherwise challenge the secured loan structure. STANDARD & POOR'S RATING PERSPECTIVES In structured financings, as elsewhere, a Standard & Poor's credit rating reflects its opinion of the likelihood that investors in a given security will be repaid in full and on time. In other words, Standard & Poor's focuses on the likelihood of timely payments of interest and on the likelihood of full return of principal by stated maturity. TRUE SALE STRUCTURED FINANCINGS n financings structured as a true sale, the true sale transfers (at least the beneficial) title in the underlying collateral from the originator to the issuer. So long as the underlying collateral or its proceeds cannot later be recaptured for the originator's estate, the true sale means that the proceeds of the collateral cannot be diverted away from investors in the asset-backed securities (ABS). For example, there should be no appreciable risk that the transfer is avoidable in the originator's insolvency as a transaction at an undervalue, which must be confirmed by legal opinions. No liquidator, administrator, receiver, or administrative receiver of the originator will have any rights in the underlying collateral. In such a true sale, from a Standard & Poor's rating perspective, the risk that the insolvency of the originator will interfere with full and timely payment is controlled. Therefore, the transaction structure and the collateral are viewed as "bankruptcy remote" from the originator. SECURED LOAN STRUCTURED FINANCINGS When an issuer seeks to structure asset-backed securities (ABS) around a secured loan to the originator, risks that affect the likelihood of full and timely payment need to be fully understood. Standard & Poor's four-level review of secured loan securities is designed to assess whether risks to full and timely payment have been dealt with. It should be noted that: Risks will arise from the status of the originator. For example, it is possible that the secured loan will, in the originator's insolvency, be avoided as a transaction at an undervalue. Legal risks will flow from the originator's entry into the secured loan transaction or will arise in relation to true control. This risk can be illustrated, in the context of English law, through the administration procedure under the Insolvency Act 1986. Administration is an English procedure similar to Chapter 11 in the U.S., with the important difference that the debtor is not in possession and the originator's business and assets are controlled by the administrator (an officer of the court). If an originator is in administration, no steps may be taken to enforce any security over the originator's assets unless leave is given by the court or the administrator. Thus, there is a risk that this automatic stay (or moratorium) will create a payment delay. Further, the administrator has power to dispose of the originator's charged assets (with or without the leave of the court depending on the nature of the security). From a Standard & Poor's rating perspective, an administrator's "forced" sale of charged assets will increase the risk that investors are not paid in full. Structural risks may arise in certain cases. Any proposed structure may, in certain circumstances, create additional incentives for creditors of the issuer or other transaction parties to file for the insolvency of the issuer or otherwise to challenge the secured loan structure. Standard & Poor's has rated ABS structured around secured loans. In all such cases, however, the special nature of the originator has made acceptable the use of the secured loan as a means of separating the creditworthiness of the assets from that of the originator. For example, in the U.S. structured finance market some entities, such as state-funded housing agencies and military agencies, are deemed analytically bankruptcy remote because of their governmental purpose and the lack of creditor incentive to file for their bankruptcy. The risk of default and of any security having to be relied on for the purposes of satisfying the claims of creditors is low. A secured loan, therefore, provides the required comfort. Bank originators of credit card receivables are another example from the U.S. structured finance market. Bank originators are not eligible to become debtors under the U.S. Bankruptcy Code, so that the automatic stay on the enforcement of security against a debtor that arises under the Bankruptcy Code is not a relevant matter. Therefore, a direct pledge of the credit card receivables has been sufficient to make Standard & Poor's comfortable with the likelihood of timely availability of receivables to pay holders of rated securities. This comfort is based on the advice of the FDIC that, on the insolvency of a bank, a first priority perfected security over the receivables will not be avoided or be subject to stay in enforcement. Where the originator is not bankruptcy remote (or is not analytically deemed to be so) or is an entity whose insolvency may interfere with the timely enforcement of the rights of its secured creditors, there is a risk that full receipt of interest and principal due on an asset-backed security will only be possible after a delay caused by an insolvency. It also is possible that in addition to delay in payment, interest and principal may not be fully recovered. Thus, from Standard & Poor's rating perspective, risks that have an impact on full and timely payment need to be fully understood and addressed through its four-level analysis before secured loan structured financings are rated. STATUS OF ORIGINATOR The first level of review is to examine the status of the originator. Arrangers and originators of secured loan securities will invariably wish to achieve a rating higher than the originator's corporate credit rating. Standard & Poor's will focus on the scope of the commercial risks associated with the originator's business activities to determine whether this is possible. A higher rating will depend on whether it is possible to identify the risks relating to a given asset or asset pool, and whether it is possible to assess with sufficient certainty the likely impact of such risks on full and timely payment. For this reason, significantly enhanced ratings are more likely to be given if the originator is a single business/single activity entity. If the originator is a multiple business/multiple activity entity, it is far more complicated to identify and measure liabilities and risks because of the variations possible as a result of the numerous combinations of risks between different business activities. Indeed, as an analytic matter, the risks may be too numerous and too immeasurable for it even to be conceptually possible to depart from the originator's corporate rating. In practice, if there is a significant possibility of a delay in timely payment, whether because the originator is a multiple business/multiple activity entity or for any other reason, the level of enhancement above the originator's corporate rating available on a secured loan structure will be small. On the other hand, if the originator is a single business/single activity entity, which makes it possible to identify and analyze closely the risks relating to the given assets or asset pool being securitized and there is ample liquidity support for a transaction structured as a secured loan, then a significant enhancement above the originator's corporate rating, perhaps even up to `AAA', might be possible. A pledge or mortgage of the shares of the issuer is one structural factor that may be relevant, especially if the issuing vehicle remains on the balance sheet of the originator. Legal opinions that there are no grouping risks arising from the issuer remaining on-balance sheet and/or nonconsolidation opinions also will be relevant in most jurisdictions. FULL ENFORCEABILITY OF SECURED LOAN AND SECURITY The second level of review is to ensure that, as a legal matter, the secured loan and the security are enforceable and not subject to any legal challenge. In a proposed secured loan structured financing, any significant risk of challenge to the enforcement of security has obvious and serious implications for any rating. Where security is unenforceable and the originator is insolvent, investors will not be paid in full. As collective insolvency proceedings begin, there also will be delay in payment. The enforcement of security over the originator's assets may be challenged under the general law or under insolvency law. These grounds are now well understood in an English law context (see General Law Challenge and Insolvency Law Challenge for a general discussion). It should not be difficult in the context of a proposed secured loan transaction to establish whether there is any significant risk of challenge that will impact on any rating. GENERAL LAW CHALLENGE The general law grounds for challenge are that: The (corporate) originator did not have capacity to grant the security; The grant of the security was known by the issuer not to be for the benefit of the originator; Factors such as misrepresentation and fraud vitiate the creation of the security; or The grant of security was, or was part of, a transaction defrauding the originator's creditors (see Insolvency Law Challenge). INSOLVENCY LAW CHALLENGE The loan agreement and/or the repayments under the loan and/or the security granted in the loan agreement may be avoided as a result of being vulnerable in the originator's insolvency. The main grounds for avoidance are: Transaction at an undervalue; Preference; Extortionate credit bargain; Transaction defrauding the originator's creditors (this is not an insolvency specific ground of challenge but the current law is found in the English Insolvency Act 1986); The grant of floating security for past value; and/or The security is not properly perfected, for example, the security is a registrable but unregistered security (see sidebar). Insolvency law challenge on these grounds is equally relevant to true sale structured financings and the legal risks are well understood. Legal opinions rendered by law firms representing the parties to the transaction usually confirm that there is no appreciable risk of the true sale being vulnerable or avoidable in the originator's insolvency. This understanding of insolvency law legal risks can also be applied to any proposed secured loan structured financing so that the risk of avoidance on the above grounds is reduced to an acceptable minimum. TRUE CONTROL The third level of review is to ensure that the issuer has true control over its security, in other words, the assets that make up its collateral. The factors that determine whether the issuer has true control are: Whether the issuer, as a secured creditor, has the conduct of (has control over) the enforcement of its security; Whether the security confers priority in favor of the issuer against all other creditors; and Whether the security is over appropriate assets and whether the proceeds of such security, once realized, are adequate to repay investors. Thus, from Standard & Poor's rating perspective, control, priority, and adequate realization are crucial. Control affects the likelihood of full and timely payment. The greater the lack of control, the greater the risk that full receipt of interest and principal due on an asset-backed security will only be possible after a delay caused by an insolvency, or even that (in addition to delay in payment) full recovery of interest and principal will not be possible. Priority is almost universally effective, though naturally any structure must have it. Whether the proceeds of any security, once realized, are enough to repay the investors will depend, in part, on the control that the issuer has over the timing of the realization of the security and, in part, over the assets over which security is granted. Standard & Poor's will focus on whether the transaction structure of a proposed secured loan structured financing meets the requirements of control, priority, and adequate realization. Where these requirements are met, Standard & Poor's will conclude that the issuer has true control over its security and that as a result full and timely payment objectives are capable of being met. Where there is no true control, there can be no rating. ACHIEVING TRUE CONTROL ENSURING THAT ISSUER HAS CONDUCT OF THE ENFORCEMENT OF SECURITY Under English law, a secured creditor is not always fully able to have the conduct of (thus, control over) the enforcement of its security. Where the secured creditor does lose control, there is a risk that full receipt of interest and principal due on an asset-backed security will only be possible after a delay caused by an insolvency. There is an additional risk that full recovery of interest and principal will not be possible at all. Where a secured creditor is able to maintain control over the enforcement of its security, these risks will be avoided. In any given jurisdiction, the balance between such control and lack of it will have an impact on the viability, from a rating perspective, of a secured loan structured financing. The following analysis concentrates on the legal position under English law. Similar principles of analysis will be relevant to the position under the laws of other jurisdictions. In the context of insolvency proceedings recognized in English law there are four matters that are relevant to determining where the balance of control lies for rating purposes. Insolvent liquidation. Insolvent liquidation (winding-up) is a collective insolvency proceeding brought about voluntarily by a resolution of the originator's members or, alternatively, compulsorily on the order of the court pursuant to a petition by, for example, a creditor. A holder of a first priority fixed security is largely unaffected by the liquidation since technically, assets subject to such security do not fall within the liquidation and such a creditor will usually have full control over the secured assets. If insolvent liquidation was the only insolvency proceeding recognized by English law, then a fixed charge (but not a floating charge) in favor of the issuer would give satisfactory comfort in terms of control. However, English law recognizes other insolvency proceedings that impact directly on control. Administration. Administration is an English procedure similar to Chapter 11 in the U.S., with the important difference that the debtor is not in possession. An administration order would be made in respect of the originator pursuant to a petition to the court presented by, for example, the originator's creditors or directors. The petition could only be presented at a time when the originator was insolvent or was likely to become so. The order would usually only be made to achieve a "better" realization of the originator's assets than would be achieved on a liquidation and/or the survival of the originator as a going concern. The originator's business and assets would come under the control of an administrator, an officer of the court. If an originator is in administration, no steps may be taken to enforce any security over the originator's assets unless leave is given by the court or the administrator. As a result of the secured creditor losing control in this fashion, there is a risk that this automatic stay (on the enforcement of security) will create a payment delay. The administrator has power to dispose of the originator's charged assets (assets subject to a security interest). The administrator's duty in relation to disposal of charged assets is to choose the right time to realize the charged assets and to obtain the market value for the sale at such time. The time of sale will be determined by reference to the purposes of the administration, not necessarily by reference to the interests of secured creditors. Where the security is floating (created by floating charge), the administrator may dispose of the charged property without the consent of the secured creditor and without the leave of the court. Where the security is fixed (created by a fixed or specific charge), the administrator requires leave of the court to dispose of the charged property without the consent of the secured creditor. This leave will be granted where to do so would help in the realization of one of the purposes of the administration order referred to above. The administrator's control, and the corresponding loss of control by the secured creditor, over the realization of charged assets thus creates a risk (both as to timing and as to value) in respect of payment. The "balance of control" in administration is weighted against the secured creditor. If the originator is in administration, there can be no true control. Blocking an administration. Secured creditors can protect themselves from the risk of loss of control in an administration by taking a floating charge, or a mixed floating and fixed charge, over the whole or substantially the whole of the originator's assets. Creditors secured in this way have power to appoint an administrative receiver. Once an administrative receiver has been appointed, no administration order will be made without the consent of the appointing secured creditor. Such creditors are entitled to notice of an administration petition (they are given advance notice that the originator may be put into administration), and therefore, have time (before the originator is in fact put into administration) to appoint an administrative receiver in respect of the originator. A secured creditor may block an administration order by appointing an administrative receiver. Administrative receivership is the means by which the creditor's security is realized. As a result, and from a rating perspective, an assessment must be made as to whether a secured creditor has control over the enforcement of its security through administrative receivership. Administrative receivership. An administrative receiver is appointed on behalf of a secured creditor to enforce its security. The administrative receiver's appointment is pursuant to a "general charge." A general charge is a charge that as created was a floating charge, or a fixed and floating charge, over the whole or substantially the whole of the property, assets, and undertaking, present and future, of a company. An administrative receiver appointed in respect of an originator will take control of all its assets and all its charged assets, with a view to receiving income from them or preserving them before disposing of them and applying the proceeds to discharge the security of the creditor that made the appointment. Thus, when an administrative receiver of an originator is appointed on behalf of the issuer, the issuer retains a greater degree of control than would ever be possible in the originator's administration. From a rating perspective, the likelihood of full and timely payment is higher. PRIORITY, NATURE OF ASSETS, AND ADEQUATE REALIZATION A general charge, which is necessary to block administration, is central to any true control structure. It will not, however, of itself be sufficient. True control further depends on both priority, and security over appropriate assets which, on realization, is adequate to repay investors. TRUE CONTROL LEGAL STRUCTURE In any proposed secured loan structured financing, Standard & Poor's will focus on whether, as a legal matter, the transaction structure gives the issuer true control over its security in the originator's assets. It is inevitable that some control will be lost as compared with a transaction structured as a true sale, and therefore, that there will always be an incremental risk that payment will not be full and timely. Standard & Poor's analysis will focus in addition on whether the transaction structure adequately addresses these incremental risks consistent with the rating level requested, by some combination of increased credit enhancement, increased liquidity support, and other structural means. A true control legal structure for secured loan transactions should encompass five areas: There is a first priority fixed charge over assets belonging to the originator absolutely (fixed charge). Standard & Poor's will focus on whether the security package defeats the claims of existing or potential creditors of the originator, including any preferential creditors. Considerable emphasis will be placed on first priority fixed security interests (which as a matter of English law rank ahead of all other creditors, including preferential creditors and holders of floating security). First priority fixed security interests should secure in full the principal and interest on the ABS. There are appropriate assets and adequate realization ("cash flow" security not "market value" security). The assets over which the first priority fixed security is granted by the originator will be highly relevant and security over them must, when realized, be adequate to repay investors. A transaction that relies on the cash flow generated by the assets could default if forced to rely on the market value realized through the sale of assets. Where the assets are receivables representing a known and certain income stream (including receivables that are expected to generate the repayments for the secured loan), security over them should be realized through the transfer of the originator's rights in those assets to the issuer (and not a sale on the open market). True control is achievable under such a "cash flow" security as there should be a little risk to full and timely payment. Where the security is over the originator's real property assets, the administrative receiver may have to sell those assets in order to realize the security. A forced sale may mean that the security over the real assets, once realized, is insufficient to provide full payment to the investors. Under such a "market value" security, there is clearly a threat to true control. Standard & Poor's will focus on the security package in favor of the issuer to determine whether, and to what extent, it meets full payment concerns.

There is a first priority floating charge over all the originator's present and future assets not caught by the fixed charge (floating charge). The combination of floating charge and fixed charge (or the floating charge alone if it is over substantially the whole of the originator's assets) is needed to block administration and appoint an administrative receiver. Under English law secured creditors with lower priority than the issuer may appoint an administrative receiver in relation to the originator. Theoretically, the issuer loses control (but not priority) over the enforcement of its security if another general charge is first to appoint an administrative receiver. From a rating perspective, if the secured loan transaction is properly structured, this risk may not necessarily lead to the conclusion that there is no control. For example, the fixed charge and floating charge mean that the issuer has priority over other existing secured creditors. Where there is no prospect of the issuer subordinating its security to existing or subsequent secured creditors, the issuer will usually be able to overreach the appointment of another administrative receiver by appointing its own. By doing so, this issuer also takes control of the originator's charged assets. In so far as this involves additional cost to the issuer, Standard & Poor's will look for appropriate support in the structure. The balance between fixed and floating security should be such that the floating charge is not primarily relied on to generate funds to repay investors. Floating charge holders do not have priority over preferential creditors (including employees and tax authorities). Further, a secured creditor's realization is always subject to equities so that where, for example, valid general law set-off rights are exercised by a borrower against the originator, the resulting diminution in the value of the security will be borne by the issuer. It is possible to cut short the build up of set-off rights in relation to assets secured by a fixed charge by giving notice of the charge to borrowers (in true sale structures the set-off risk may be similarly contained). Notice of floating charges does not cut short the build up of set-off risk, which is a risk that continues until the floating charge crystallizes. There is an agreement by the originator not to create any further fixed or floating security over its assets that secure the secured loan structure or not to do so until any new secured creditor is party to an intercreditor agreement giving priority to rated debt. Where appropriate, additional features could assist in increasing the level of enhanced rating above the originator's corporate rating. For instance, either an intercreditor agreement to create the priorities referred to above with respect to the fixed charge and the floating charge; or an intercreditor agreement to prevent general chargees, other than the issuer, from appointing receivers or administrative receivers may affect the balance of true control. Thus, either of these agreements could affect how much a rating could be enhanced above the originator's corporate rating. Similarly, in circumstances where an originator has other creditors apart from those involved in the securitization, the absence of appropriate intercreditor arrangements may impact on the analysis of the level of liquidity/credit enhancement required for a particular rating. Standard & Poor's will seek legal opinions concerning all these aspects of the transaction's legal structure. LIQUIDITY SUPPORT AND ADDITIONAL STRUCTURAL CONSIDERATIONS In addition to the legal considerations outlined above, Standard & Poor's analysis of financings structured as secured loan transactions will focus on whether the transaction structure adequately addresses the incremental legal risk flowing from loss of true control. Factors relevant to this analysis will include: Increased liquidity support to cover adequately the timeliness risk associated with the enforcement of security, including automatic stays and moratoriums. As an analytical matter, sizing timeliness risks will always be a difficult task. Incremental credit enhancement to cover the increased risk of loss of value of collateral resulting from the loss of true control. Structural and analytical factors present in the transaction to assure that the secured loan structure achieves bankruptcy remoteness from the originator and to reduce the risk that creditors of the originator or any other persons have any perceived incentive to file for bankruptcy of the issuer, or otherwise to challenge the secured loan structure. Standard & Poor's is willing to work with originators and arrangers to establish whether particular financing transactions structured as secured loans address the risks discussed in this article sufficiently to enable the structure to be treated as bankruptcy remote from, and thus capable of being rated higher than, the rating of the originator. Standard & Poor's will work with these parties either by any of the means outlined above, or in other ways that originators or arrangers may care to suggest.