Article Title: ARCHIVE | Criteria | Corporates | General: Securitization's Effect On Corporate Credit Quality Data: (EDITOR'S NOTE: —This criteria article is no longer current. It has been superseded by "2008 Corporate Criteria: Ratios And Adjustments, Encyclopedia Of Analytical Adjustments" and "2008 Corporate Criteria: Rating Each Issue, Reflecting Recovery In Issue Ratings" both published on April 15, 2008.) (Note: The focus of this article is on securitizations undertaken by industrial companies--not by financial institutions, which use securitization extensively to fund mortgage and credit card loans, as well as other types of finance assets. Nevertheless, Standard & Poor's Ratings Services' fundamental approach to analyzing securitization is the same in both the industrial and banking sectors.) Asset securitization is a form of financing that has been widely used across industries and across the rating spectrum. Securitizations are important financing sources for many companies, often providing both lower cost and more diverse sources of funding and liquidity than available to the company otherwise. The ability to securitize assets provides additional financial flexibility and is regarded as a positive credit factor. Apart from this, though, securitizations do not ordinarily transform the risks or the underlying economic reality of the business activity--that is, provide what is commonly referred to as "equity relief." Equity relief is rarely achieved when a company has a recurring financing requirement, in contrast to one that uses securitization only as a means to monetize a non-core asset on a one-time basis. If securitization is used to supplant other debt, its effect on credit quality is likely to be close to neutral. Because the accounting treatment of securitization frequently is not congruent with Standard & Poor's Ratings Services' analytical perspective, adjustments to the reported financials are often necessary. In the event of a bankruptcy, an issuer's reliance on securitization can be detrimental to the ultimate recovery prospects of unsecured creditors-–and so may well warrant notching down of unsecured debt issue ratings from the issuer credit rating. What Is Securitization? A securitization is a means of obtaining financing, but it is not accomplished through a borrowing arrangement in the traditional sense. In a securitization, an asset or pool of assets is sold in a "true sale" to a bankruptcy-remote entity, variously referred to as a securitization trust, special-purpose vehicle (SPV), special-purpose entity (SPE), or variable-interest entity (VIE). This entity funds the transaction by issuing debt, equity, or other forms of beneficial interests. Subsequently, the debt is serviced exclusively with cash flow generated from the trust's assets. Because the trust is bankruptcy-remote, its debtholders are insulated from the default risk of the issuer. (Securitizations are often effected using a series of trusts to achieve the desired legal isolation.) Further protection is afforded to trust debtholders through "enhancement" in the form of overcolleralization. That is, the debt issued by the securitization trust is less than the value of the assets, and the difference between the two is the so-called "first-loss" exposure. This exposure can take different forms, including subordinated interests in trusts, cash reserves, and deposits due from trusts. Another form of enhancement can be the accumulation by the trust of excess cash flow, also referred to as "excess spread" or "interest-only strips." This is the difference between cash inflows from the securitized assets and cash outflows related to debt service, servicing fees, and other expenses. Some securitizations "trap" a portion of this cash within the deal structure to further protect debtholders. Securitizations also frequently incorporate enhancements provided through third parties, including bond insurance, liquidity facilities, and credit derivatives. Furthermore, securitizations commonly include performance-based early amortization and reserve funding triggers. Securitizations can be amortizing, in which one asset or pool of assets is sold at the initiation of the transaction and then is liquidated over a stipulated period. Or, they may be "revolving" in the sense that liquidating assets are replaced by new assets sold by the issuer into the trust. Securitization trusts may be associated with a single corporate seller of assets (single-seller conduits) or incorporate several corporate sellers (multiseller conduits). Corporations commonly securitize a wide range of assets, including-–to give just a few examples--finance and lease receivables, trade receivables (including existing and future export receivables), inventory, transportation equipment, timberlands, trademark licenses, royalties, receivables from tax authorities, and stranded costs of electric utilities. Benefits Afforded By Securitization Securitizations are important financing sources for many issuers, adding to the range of other secured and unsecured funding alternatives. For some marginal or distressed companies, securitization may be the only accessible form of obtaining financing; investors may be too wary of the company's poor prospects to lend directly, but might still be willing to lend against the company's discrete assets when coupled with all the structural protections afforded by securitization. In addition, securitization may facilitate match-funding, as the term of securitized debt generally mirrors the life of the underlying assets. Securitization also provides access to relatively low-cost financing in many instances. However, the cost of the securitization transaction encompasses more than just the coupon rate of the securitized debt: the costs related to all the different forms of credit enhancement must also be weighed, as well as incremental administrative costs. Moreover, securitization may weigh on the cost of other financings because the overcollateralization enjoyed by securitized debtholders can put unsecured creditors at a disadvantage, as discussed below. In thinking about the financial flexibility benefits provided by securitization, one must also be sensitive to the risks posed by financial covenants or other credit triggers included in the securitization. In revolving securitizations, triggers are commonly tied to the performance of the underlying assets, which, when triggered, stop the sale of additional assets and cause all cash flow of the securitization to be used for debt amortization. This can result in liquidity challenges and cause a "credit cliff" situation for the company. Does Securitization Bring Equity Relief? Many market participants think of securitization's effect on an issuer's credit quality almost exclusively in terms of "equity relief," that is, the notion that by having completed a securitization, the issuer is able to retain less equity, or incur more debt, than would otherwise have been the case, without any change in its credit quality. For Standard & Poor's, equity relief is one potential aspect of the analysis of a securitization's effect on an issuer's credit quality. We gauge equity relief in terms of risk transfer: equity relief is achieved only to the extent the risk related to securitized assets is transferred to the securitization debtholders. We do not approach this matter in black-and-white terms, but instead view the potential outcomes along a spectrum. To the extent that the securitization accomplishes true risk transference, the transaction is interpreted as resembling an asset sale, whereas in the much more common case where the issuer retains the bulk of risks related to the asset, the transaction is akin to a secured financing. Key considerations include the following: The riskiness of the securitized assets. The only risk that can be transferred is that which existed in the first place. If, as is often the case, an issuer securitizes its highest-quality or most liquid assets, that limits the extent of any meaningful equity relief. First-loss exposure. The issuer commonly retains the first-loss exposure, thereby enhancing credit for the securitized debt. For the securitized debt to be highly rated, the extent of enhancement must be a multiple of the expected losses associated with the assets. The first-loss layer thus encompasses the preponderance of risk associated with the securitized assets, and the issuer's total realizations from the securitization will vary depending on the performance of the assets. Often, only the risk of catastrophic loss is transferred to third-party investors–-risk that is generally of little relevance in the corporate rating analysis. Moral recourse. This refers to how the company would behave if losses did reach catastrophic levels. Empirical evidence suggests that companies often feel they must bail out troubled financings (for example, by repurchasing problematic assets or replacing them with other assets) to preserve access to this funding source and, more broadly, to preserve their good name in the capital markets, even though they have no legal requirement to do so. Moral recourse is magnified when securitizations represent a significant part of a company's financing activity or when a company remains linked to the securitized assets by continuing in the role of servicer or operator. Ongoing funding needs. Even if it were certain that the risks related to a given pool of assets had been fully transferred and the issuer would not support failing securitizations, equity relief still would not necessarily have been achieved. If, for whatever reason, losses related to the securitized assets rose dramatically higher than initially anticipated, and if the issuer has a recurring need to finance similar assets, future access to the securitization market would be dubious–-at least economically. Future funding needs would then have to be met by other means, with the requisite equity to support them. Thus, even if a company separately sells the first-loss exposures, or sells the entire asset without retaining any first-loss exposure, it may achieve little equity relief. (See for example, "Auto Whole Loan Sales Bolster Automakers' Funding Flexibility," published March 15, 2004, on RatingsDirect, Standard & Poor's Web-based research and credit analysis system.) Our experience has been that expectations regarding equity relief are often exaggerated. The fact is, minimizing funding costs for the issuer while transferring significant risk to the investor tend to be mutually exclusive. Accounting Aspects Convoluted and form-driven accounting rules under U.S. GAAP complicate the task of assessing companies' uses of securitizations. Under SFAS 140 ("Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities"), certain specifically defined securitizations effected through securitization trusts termed "qualifying special-purpose entities" (QSPEs) are treated as asset sales, with the securitized assets and related debt being off-balance-sheet. Yet, QSPEs, which are "passive" in nature and narrow in scope of activities, include securitizations of recurring finance receivables—a securitization type where there is typically little basis for supposing risk transfer has occurred, based on the factors enumerated above. Otherwise, under FASB Interpretation Number 46-Revised (FIN 46R; "Consolidation of Variable Interest Entities"), a company must consolidate a securitization trust--here termed a VIE--if the company is deemed to be the "primary beneficiary" of the VIE trust (unless the VIE is a QSPE under SFAS 140). Under FIN 46R, a company is considered the primary beneficiary if it holds a variable interest(s) in the VIE, which will absorb most of its expected losses, receive most of the expected residual returns, or both. Variable interests are defined in terms of the rights and obligations that convey economic gains or losses from changes in the values of the VIE's assets and liabilities. According to FIN 46R, a company with the majority of the risks or rewards associated with a VIE's activities is essentially in the same position as the parent in a parent/subsidiary relationship. Applying the rules for tallying variable interests is highly subject to judgment and estimates. In addition, some companies tailor the terms of securitizations specifically to fail the tests for off-balance-sheet treatment--which can be achieved without substantially modifying the underlying economics of the transaction--feeling their financial statements are thereby more transparent. Other companies prefer the minimization of apparent financial leverage that can result from off-balance-sheet treatment. Management's accounting objective may also be influenced by income statement-related considerations: some companies prefer to avoid the volatility associated with upfront gain recognition, preferring the more smoothed earnings recognition pattern generally afforded by on-balance-sheet accounting for securitizations. (Note: FASB has recently proposed an amendment to SFAS 140 that would require companies to record upfront gains on sales and mark-to-market all securitized assets and liabilities [including any retained portions], as well as affording optional fair-value or amortized cost accounting for servicing rights.) Further muddying the waters: the IFRS framework is very different from that of U.S. GAAP. Thus, even when transactions have the same economic substance, the accounting treatment can vary. Analytical Adjustments Our analytical treatment of securitizations is not dictated by the accounting treatment. Rather, we seek to understand the economic substance of the transactions. In calculating financial ratios that assist us in assessing debt leverage, profitability, and cash flow, we adjust financial statements as necessary to be in accordance with our analytical perspective and to enhance comparability among issuers. Capital structure For capital structure ratio calculations, the analytical treatment will vary depending on the degree to which risks are transferred. For transactions in which a company retains the preponderance of risks (including those related to ongoing funding needs), we calculate ratios where the outstanding amount of securitized assets are consolidated, along with the related securitized debt—-regardless of the accounting treatment. If securitization is used essentially to transfer risk in full and there are no contingent or indirect liabilities, we view the transaction as the equivalent of an asset sale. When necessary, then, we recast the assets, debt, and shareholders' equity accordingly, including adjusting for deferred tax effects. (In some cases, the securitization gives rise to a deferred tax liability that accrues over the life of the transaction and is ultimately payable when the transaction matures. Given the visibility of this liability and the high likelihood that it will ultimately become payable, in contrast to deferred tax liabilities in general, it may be appropriate to treat this as a form of debt.) Profitability When securitizations are accounted for as sales, they commonly give rise to upfront "gain-on-sale" effects, which represent the present value of the estimated difference between the asset yield and the securitization funding rate and other securitization-related costs. For securitizations in which a company retains the preponderance of risks, it is appropriate to back out such gains and spread them out over the life of the securitizations, given the uncertainty about whether the earnings will ultimately be realized as expected and to give a clearer picture of the company's recurring earnings. In theory, it may be desirable to fully recast the income statement—-for example, consolidating off-balance-sheet securitization transactions not involving risk transference. As a practical matter, though, this is difficult to accomplish without the detailed assistance of management. Some companies have voluntarily included such pro forma schedules in their public disclosures. Cash flow In accordance with SFAS 95 ("Statement of Cash Flows"), any cash inflows/outflows related to working capital assets or liabilities, or finance receivables, are classified as "operating" in nature on the statement of cash flows. Hence, inflows/outflows from related securitizations affect operating cash flow, with particularly significant effects possible in reporting periods when securitizations are initiated or mature. The reporting convention varies, though, in line with the balance sheet classification. If the securitization is consolidated, the related borrowings are treated as a "financing" activity. If the securitization is not consolidated, it is as if the assets self-liquidated on an accelerated basis: no debt incurrence is identified separately, either as an operating or financing source of cash. When our analytic view is that securitizations should be consolidated (or, in rare situations, when those that are consolidated should not be), it would be desirable to recast the statement of cash flow accordingly–-to smooth out the variations in operating cash flow that can result from the sale treatment of the securitization, which can give a distorted picture of recurring cash flow. Again, though, as a practical matter, this can be difficult to accomplish without the company's assistance. Ultimate Recovery Aspects Use of securitization may pose concerns regarding ultimate recovery prospects for unsecured debt in the same way that securing some debt with valuable assets relegates the unsecured debt to junior status. Thus, where sufficiently material, this may warrant notching down of unsecured debt issue ratings and needs to be taken into account in assigning recovery ratings to other debt issues. Like secured debtholders, securitization debtholders have a priority claim to a designated pool of assets. If the issuer becomes insolvent, unsecured debtholders would receive a direct benefit from the encumbered assets only if the value of those assets was more than sufficient to meet the secured/securitized debtholders' claims. This implies "subordination" of unsecured debt and of debt secured by lower-quality assets, which becomes potentially more threatening the greater the percentage of assets that are securitized. In the case of securitization, however, if the value of the encumbered assets is insufficient to satisfy the claims of the securitized debtholders, those debtholders have no claim on the issuer's unencumbered assets (that is, as long as the company does not extend any guarantee to the securitization). (Note: Whether the securitization has been consolidated or deconsolidated for financial reporting purposes has no bearing on the legal treatment in bankruptcy.) Therefore, as long as the securitized and unsecuritized assets are of roughly uniform quality, i.e., equally subject to erosion in value, the securitization transactions should not be detrimental to the ultimate recovery prospects of unsecured creditors, particularly if the securitization proceeds are used to repay unsecured debt. If the securitization transactions are more highly leveraged than those of the rest of the issuer, securitization creates a potential relative benefit for the unsecured debtholders. Obviously, though, if better-quality assets are securitized while inferior ones are left unencumbered on the balance sheet-–which is most often the case--the result is that unsecured debtholders are disadvantaged. Particularly in view of the increasing use of securitizations by corporates, we invite comments from any market participants regarding this article.