Opportunities to Securitize —
Valuable Lessons Issuers Should Consider

BY MILES HERMAN

Throughout the recession period and beyond, the securitization industry has undergone significant changes. Miles Herman walks us through how certain trends and key practices over the last several years have yielded a number of valuable lessons that issuers should consider.

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The equipment leasing and finance industry is currently enjoying a period of steady funding. Many of the companies in the industry have utilized the securitization marketplace for a source of funding. The securitization industry has undergone much change in the last 10 years. This article will discuss the changes in the securitization marketplace, the regulatory reforms enacted to promote transparency and some trends and key practices that lessors can adopt to aid in improving their opportunities in the securitization marketplace.

Pre-Recession Period

Seasoned issuers with long institutional memories cannot forget the past 10 years. From 2004 to early 2007, liquidity from the securitization marketplace was strong. Credit was readily available and borrowing rates were low with blended spreads less than 100 basis points. The issuers were able to structure transactions with higher leverage. During this time of prosperity, highly structured transactions were available and institutions of all sizes, from small independent lessors to large publicly traded leasing and finance companies, issued bonds through the asset backed securities (ABS) marketplace. Fueled by this liquidity, institutions expanded and originated more leases and loans. Independent leasing companies were able to better compete with larger financial institutions as a result of the lower cost of debt provided by the ABS marketplace. This expansion also occurred in the mortgage and credit card industries.

While structures today are typically very "vanilla," other structures are being adopted. These structures can often help rating agencies become more comfortable with a wider range of issuers.

Recession Period

While the recession period varies from country to country, the U.S. economy fell into a recession beginning in mid-2008. During this period, the leasing industry, as well as many others including the mortgage, credit card and student loan industries, experienced an increase in delinquencies and write-offs. Lenders and lessors saw a significant tightening of credit, lower leverage and wider spreads.

Banks reduced lending to leasing companies and larger financial institutions. Banks from the European Union with American affiliates were subjected to Basel II and III; the liquidity of the U.S. banks was being challenged. This caused many banks, both foreign and domestic, to merge or consolidate. Many traditional lenders to the equipment leasing market reduced their involvement, stopped lending altogether, or simply left the space because limited securitization opportunities hampered their takeout strategy. ABS investors also struggled when many bonds were downgraded by the key rating agencies. During this period, only the strongest issuers were able to come to the ABS marketplace, and only then by paying a premium in the form of wider spreads.

The federal government intervened through the U.S. Treasury with two main programs — its Troubled Asset Relief Program (TARP) and its Quantitative Easing Programs (such as QE1 and QE2). At its peak, the Treasury Department purchased $2.1 trillion in bank debt, various asset and mortgage securities, and U.S. Treasury Notes. Despite these efforts, liquidity in general remained weak.

Outcries for reform mounted and various governmental reforms were enacted. The Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law in July 2010, represented major regulatory reform in the U.S. and had a profound impact on securitized transactions. Section 941 of the Dodd-Frank Act mandated at least 5% of the credit risk of each securitization be retained by issuers. The new Rule 17g-5 under the Securities Exchange Act of 1934 (Exchange Act) mandated that all information provided to the rating agencies must be placed on a password protected website with access granted to all rating agencies.

Later, in September 2011, the SEC enacted Rule 17g-7 under the Exchange Act requiring rating agencies to provide information whenever the transaction structure or representatives and warranties were different than similar transactions. Finally, the Securities Exchange Commission proposed rules under Regulation AB (Reg AB II). These rules would impact both public and private securitization issuances with regard to the disclosure of loan-level information relating to the transactions in their securitizations. This piece of legislation has not yet been signed into law and has been met with resistance by many members of the industry involved with securitization.

Post-Recession Period

The post-recession economy appears to be growing slowly with a gross domestic product under 4%. Companies are hoarding cash on their balance sheets rather than expanding their workforce. Equipment acquisitions by end-users have remained inconsistent even over the last 18 months. The tax benefits extended through §179 of the Internal Revenue Code have not significantly moved the overall equipment acquisition cycle for end-users much beyond replacement acquisitions (replacing only the equipment that is no longer functional). New business formation also continues to lag compared to other post-recession periods of recovery. In addition, many articles and studies indicate that small businesses were still unable to borrow from their local bankers during the early phase of the post-recession recovery.

Quantitative Easing Three (QE3) was launched in 2012 with the U.S. government starting monthly purchases of $40 billion in mortgage-backed securities. This was expanded in December 2012 to $85 billion every month. By June 2013, a "tapering program" was announced to scale back these purchases. The tapering program appears to have brought in more investors, serving to strengthen the marketplace while adding liquidity to the space. Ultimately, equipment lessors who issued ABS securities returned to the space and grew the issuance levels beyond pre-recession levels. Overall, although U.S. ABS issuance in 2013 was down to $194.6 billion versus $220.1 billion in 2012,[1] equipment ABS issuance levels in 2012 and 2013 still exceeded pre-recession levels of 2005-2007.[2]

A historical review shows the leasing industry fared better than other financial sectors due to lower delinquency and write-off results during the recession. The portfolio performance results of the equipment issuances in the ABS market performed better when compared to those in credit cards, student loans, collateralized debt obligations and the mortgage industry.

In the early part of the post-recession, equipment acquisitions were down even though there was end-user demand for capital. More recently, a new lending model called "peer-to-peer" that matches borrowers with non-traditional lenders is evolving to provide business loans. Equipment acquisitions have been inconsistent across all equipment classes of the leasing industry. Over the last 12 months, there has been fierce competition by many lessors, finance companies and banks to meet the increasing end-user customer demand for equipment financing. More normalized credit practices are present today due to the persistent low delinquency and write-offs.

The stronger performance during the recession as well as the continued low delinquencies and write-offs during the post-recession period are motivating banks to once again lend actively to the leasing industry. More often than not, the bankers want the equipment leasing and finance companies to become issuers in the ABS market. The net effect of this trend over the last 12 months is that smaller, independent issuers are once again issuing securitizations through the capital markets. Some of these equipment lessors who are first-time issuers are smaller, independent leasing companies. While structures today are typically very "vanilla," other structures are being adopted. These structures often help rating agencies become more comfortable with a wider range of issuers.

Interview a number of bankers and gather terms sheets from various sources. While one needs to understand all the terms and conditions, lessors should pay close attention to the possibility of a multi-year facility, reasonable fees and rates, and acceptable concentrations and covenants.

Tips for Success

The last several years have yielded a number of valuable lessons that issuers should consider.

1) A well-developed business plan is essential. Issuers should think through and document precisely how the business origination and servicing model will function.
2) Develop and maintain a credit "box." It is critical to lenders, investors and rating agencies for the issuer to not only have a clear set of credit parameters, but more importantly, to operate from within this "box."
3) Implement an efficient platform and servicing model. It is important to have a solid platform and servicing model that is functional, cost-effective and efficient. The platform can be enterprise or cloud based. Outsourcing can be utilized as well. Payment lockboxes and accounting services can also be outsourced.
4) Utilize a back up servicer, collateral custodian and lockbox party. Rating agencies and investors under a securitization will almost invariably require a reputable back-up servicer, collateral custodian and lockbox party.
5) Choose the investment banker wisely. Seek a banker with the experience and range of services to support the issuer's needs throughout the entire business life cycle. Interview a number of bankers and gather terms sheets from various sources. While one needs to understand all the terms and conditions, lessors should pay close attention to the possibility of a multi-year facility, reasonable fees and rates, and acceptable concentrations and covenants. Also, it is important to utilize an experienced attorney to structure the credit facility and securitization.
6) Have a process to provide quality reporting regularly to the investment banker, the rating agencies and ultimately to the investors. In this business, like all businesses, confidence is built through quality, transparent information. This is critical to any issuer hoping to issue on a regular basis.

Forecasts for the balance of 2014 in the ABS marketplace appear to be steady. These lessons along with a stable economy and a solid ABS marketplace can be crucial for the overall health of the industry.

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1 *Asset Backed Alert*, June 2014
2 Credit Suisse, December 2013