

## Feature

### KEY POINTS

- The cause of the currency mismatch raises a set of its own issues.
- A devaluation of the member state's new currency following departure, absent limited recourse provisions, could result in the issuer being balance sheet insolvent.
- A redenomination of the notes would require super majority approval of all classes of noteholders.

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# Why the impact of a Eurozone departure on an ABS securitisation differs to that on the loan market

This article considers the practical implications for the asset backed securitisation market of a member state departure from the Eurozone.

## INTRODUCTION

Financial difficulties in the Eurozone continue, periodically, to dominate headlines. The possibility of a country abandoning the Euro and redenominating its currency has inspired much legal and practical commentary (see, for example, articles in this journal in January, April,

June, August and November 2012).

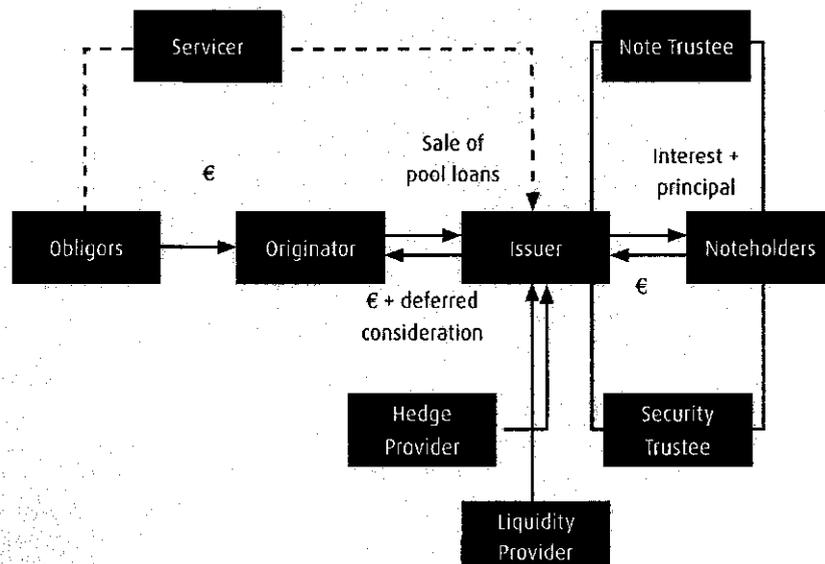
However, the majority of discussions on these topics have tended to consider the effect of such an event on general financing facilities (bilateral and syndicated) and derivatives transactions. Limited analysis of the impact of a departing state from the Eurozone on the asset backed securitisation

(ABS) market has taken place to date. This article fills this gap in commentary and considers the impact of a Eurozone departure on a typical ABS securitisation transaction.

This article will consider the impact of an unnamed country within the Eurozone (which, for sake of ease will be named Exeat) exiting the Eurozone on a typical ABS securitisation where the underlying assets derive from consumer finance contracts in Exeat.

A typical ABS securitisation structure is set out in the opposite diagram.

## CLASSIC ABS STRUCTURE SECURITISING POOL OF LOANS



In the diagram above, a bank in Exeat (the originator) sells a portfolio of mortgages (each such mortgage secured against a property, or properties, in Exeat) to an SPV (the issuer). In this scenario, the issuer is incorporated in a jurisdiction outside Exeat. The issuer raises funds for the purchase of the portfolio of mortgages by issuing notes (usually in a number of different classes) in the capital markets. The notes issued are euro denominated, as are the underlying assets. The issuer uses the income from the portfolio (which includes interest and principal payments under the mortgages) to repay principal and interest on the notes. The issuer will have no recourse to the originator for any shortfalls in funds.

## WHY WOULD THE IMPACT ON AN ABS SECURITISATION BE DIFFERENT TO THAT ON THE LOAN MARKET?

Some of the issues which an ABS securitisation with underlying Exeat assets might face on the departure of Exeat from the Eurozone are similar to those faced in the loan market (which have been previously analysed).

However, owing to the structure of ABS securitisations, there may also be a number of issues which are unique to typical ABS securitisations.

This is due to the fact that, in an ABS securitisation, the noteholders (who effectively are the lenders) do not have recourse to the originator (effectively the borrower); rather they only have recourse to the assets. This means that the impact of Exeat's departure on an ABS securitisation backed by Exeat originated assets is analysed with reference only to the assets (with no recourse to the originator or the assets of the originator).

## WHAT COULD HAPPEN ON EXEAT

## LEAVING THE EURO?

As mentioned earlier, under an ABS securitisation, the income from the assets is used to repay the notes issued by the issuer. Where the assets and the notes are denominated in the same currency, there is no currency mismatch. Where this is not the case, currency swaps based on a certain exchange rate will often be put in place at closing which effectively mitigate the currency mismatch which would otherwise exist in the securitisation.

However, in the event of Exeat departing the Eurozone, it is highly likely that obligations owed by parties based in Exeat would be redenominated in the new currency (which we will call E\$). We expect that this is particularly true for consumer finance obligations, as it is unlikely that Exeat would expect its consumers to continue to meet their obligations under mortgages or other consumer financings in a currency no longer the official currency of Exeat.

Even though the mortgages underlying the ABS securitisation have been sold to an issuer SPV incorporated outside Exeat, and as such, are no longer owned by the Exeat bank which originated them, the expectation is that the mortgages would be subject to compulsory redenomination, as liabilities of consumers in Exeat. This redenomination would result in a currency mismatch between the income of the issuer (which would be redenominated in E\$) and the liabilities due to the noteholders (which would remain denominated in Euros – typically the documentation does not include provisions which allow for compulsory redenomination of the notes on redenomination of the underlying assets).

## Currency devaluation

On the basis of the above analysis, on redenomination of currency in Exeat, our ABS would be subject to a currency mismatch. As mentioned, in ABS deals, one can structure around currency mismatches. However, the cause of this currency mismatch raises a set of its own issues.

One issue which is common to all

discussions regarding the impact on a member state leaving the Eurozone is the potential devaluation of the member state's new currency following departure. Arguably, given the reason for Exeat's departure from the Eurozone, the exchange rate for € to E\$ (which would presumably mirror that set at the implementation of the single currency arrangements) would be unlikely to hold. The E\$ may fall in value so that an exchange rate set at €1 = E\$1, may, in an extreme example, reset to €1 = E\$4, or worse.

The impact of devaluation on an ABS securitisation is self-evident. When ABS securitisations are structured, the amount of debt raised by the issuer will be less than the value of the assets underlying the structure. However, the over-collateralisation is generally limited, such that 90 of notes may be issued backed

whether the issuer needs to be placed into some form of liquidation. This could result in further losses to the noteholders.

## Exchange rates and foreign exchange swaps

Even assuming that the insolvency point was not a concern for the issuer, there still would be the matter of managing liabilities in one currency with assets in another currency. The issuer may be able to exchange its E\$ for € on the foreign exchange market. However, as seen in a number of the *Eurosail* deals following the collapse of Lehman Brothers, this is not a straight forward process.

Even with effective currency exchange management, where devaluation occurs, sooner or later such decrease in the asset values (and their cash flows) would be a shortfall of income to liabilities, which would cause a payment default in the structure.

Where a structure has the benefit of limited recourse provisions, this situation may not be problematic ...

by assets with a value of 100. As the noteholders only have recourse to the assets, any devaluation of the E\$ would result in a fall in the value of the underlying assets in terms of € value.

## Solvency considerations

This raises questions regarding the solvency position of the issuer. Taking into account the new €/E\$ exchange rate, the issuer's liabilities are likely to exceed its assets. Where a structure has the benefit of limited recourse provisions, this situation may not be problematic (as the issuer would know that its liabilities are effectively limited to its assets). However, where issuers are unable to issue notes with limited recourse provisions (as was the case with English issuing vehicles prior to the implementation of Taxation of Securitisation Companies Regulations 2006), this devaluation may result in the issuer being balance sheet insolvent. When combined with potential cash-flow issues, this may mean that the directors of the issuer need to consider in a timely manner

As an alternative to ongoing FX management, the issuer could enter into a E\$/€ swap, which would give it comfort that on each payment date it would be able to exchange its income in E\$ into € to settle its liabilities. However, it is likely that the counterparty to any such E\$/€ currency swap would charge a high premium for the swap, representing an additional cost to the issuer. The issuer would need to consider this cost against the potential costs of entering into periodic foreign exchange trades on the spot market.

Further, there may be a shortage of counterparties willing to enter into a E\$/€ currency swap, irrespective of the size of the premium. If the notes are subject to a credit rating (which is often the case in ABS deals), the counterparty would need to have a certain minimum rating. It may be that this is less of a concern, as the issues set out in this analysis may impact the rating of the notes. However, in the abstract, there is currently a shortage of appropriately rated financial institutions that are willing to provide swaps to ABS

## Feature

### Biog Box

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securitisations in the European market. Whether any of these counterparties would have an appetite for E\$ risk is a question which is impossible to answer.

### Restructuring the notes in E\$

The final issue to consider is the possibility of redenominating the notes into E\$ obligations of the issuer. This would require amending the terms of the notes.

As mentioned earlier, in ABS securitisations, the issuer will typically issue more than one tranche of notes. The notes are subject to a strict order of priority which governs the rights and priority of each class. In many ABS securitisations, you look to the interests of the most senior class of notes for a large number of matters, including making certain amendments to the documents.

However, some amendments, deemed

possible. Conversely the various classes may have quite different preferences for dealing with the issue.

The most senior class of note may want the structure to default in which case the assets can be liquidated and, depending on the level of subordination of more junior notes and the E\$/€ exchange rate, the most senior class of noteholders may be able to exit the structure with full repayment of principal and interest at the expense of the more junior classes of notes. In this scenario, the junior notes, who would be most at risk to any loss in the portfolio, may support any restructuring which minimises their losses due to the redenomination. Similar issues between noteholders (sometimes called "tranche warfare") have arisen in the European CMBS market over the last few years, although these have not had to deal with the added pressure

incorporated in Exeat, it may be that legislation redenominating obligations in Exeat also mandates the redenomination of the notes issued by the issuer.

In this scenario, many of the issues which arise in non-ABS financing may apply to the redenomination of the notes, and as such, these will not be discussed in this article.

### CONCLUSION

It is clear from the discussion above that a variety of potential problems arise for issuers and noteholders alike in the scenario where notes are issued in one currency, but backed by assets which, following a country's departure from the Eurozone, are subject to mandatory redenomination. Currency mismatch, solvency, cash-flow, and devaluation are just some of the likely problems which may arise in such a scenario. From our experience with ABS restructurings and defaults over the last few years (which although based upon different scenarios to a redenomination has analogous implications for this discussion), these problems will necessarily be dealt with on a case by case basis, requiring an analysis of the specific terms of applicable ABS documents and parties' respective rights and obligations thereunder. ■

## Currency mismatch, solvency, cash-flow, and devaluation are just some of the likely problems ...

"Basic Terms Modifications", are considered fundamental to the interests of all classes of noteholders and so require consent from all classes. A redenomination of notes from € to E\$ would fall within such category. Such amendments do not necessarily require every noteholder's approval, but they would most likely require a super majority of noteholders of each class to agree to the redenomination.

Where the interests of each class of noteholders are aligned, for example where not redenominating the notes adversely affects each class, such consent may be

of redenomination of assets and possible decline in exchange rates (rather they have had to deal with a decline in the value of the underlying assets only).

Further, this analysis does not attempt to address the question of whether the noteholders would have any interest in holding E\$ assets.

### Exeat securitisations

The above analysis has assumed that the notes themselves were not also subject to a redenomination. If the issuer was

<sup>1</sup> The authors are grateful for the comments to this article of Andrew Petersen, a structured finance partner at K&L Gates and Diana Ford, special counsel in structured finance at K&L Gates.

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