CLIFFORD
CHANCE

Briefing note November 2016

Securitised Origination Warehouse Financing – a flexible funding tool

A notable theme in the European securitisation market in recent times has been the move towards securitised warehouse financing facilities as a means of providing funding for originators of mortgage loans, auto leases and other consumer assets. Whilst the use of warehouse financing of itself is not a new phenomenon and has been an important funding source for many originators for many years, the current changeable nature of the public markets, combined with lenders willing to lend on an asset-backed basis has made warehouse financing an increasingly attractive option.

Securitised warehouse financing can be broken down into three broad categories. First, are warehousing transactions where a lender provides asset-backed loan or note facilities to a borrower to acquire a portfolio of assets in the market. Such "portfolio acquisition" warehousing is usually seen as an interim step, where a public market refinancing is being readied and will be implemented as soon as market conditions permit. There are a number of ways in which the transaction can be structured and documented, though such transactions will typically be quite bespoke in terms of meeting the requirements of the borrower and lenders and will look quite different to the structure for a public asset-backed deal.

The second broad category of warehousing transaction is those that have the broad features of a public transaction (the notes may be listed and cleared, for example) but where the notes are preplaced on closing with a small number of key relationship lenders. Again the intention may be to support the financing of a portfolio acquisition by the borrower or alternatively, own originations of the borrower, though this second category has the advantage that such financing can be more quickly refinanced in the public market by the lenders, as the transaction is already in a form that can be more widely marketed to other investors.

The third broad category of warehouse financing, which can be termed "origination warehouse financing," is asset-backed financing that may be an attractive long-term option to smaller or start-up originators who are looking for a flexible funding solution in order to grow the business and may have no immediate desire to approach the public markets, though this may be the ultimate goal. In such circumstances, obtaining funding on a relationship basis with a small number of key funders may better equip such originators to meet their strategic objectives.

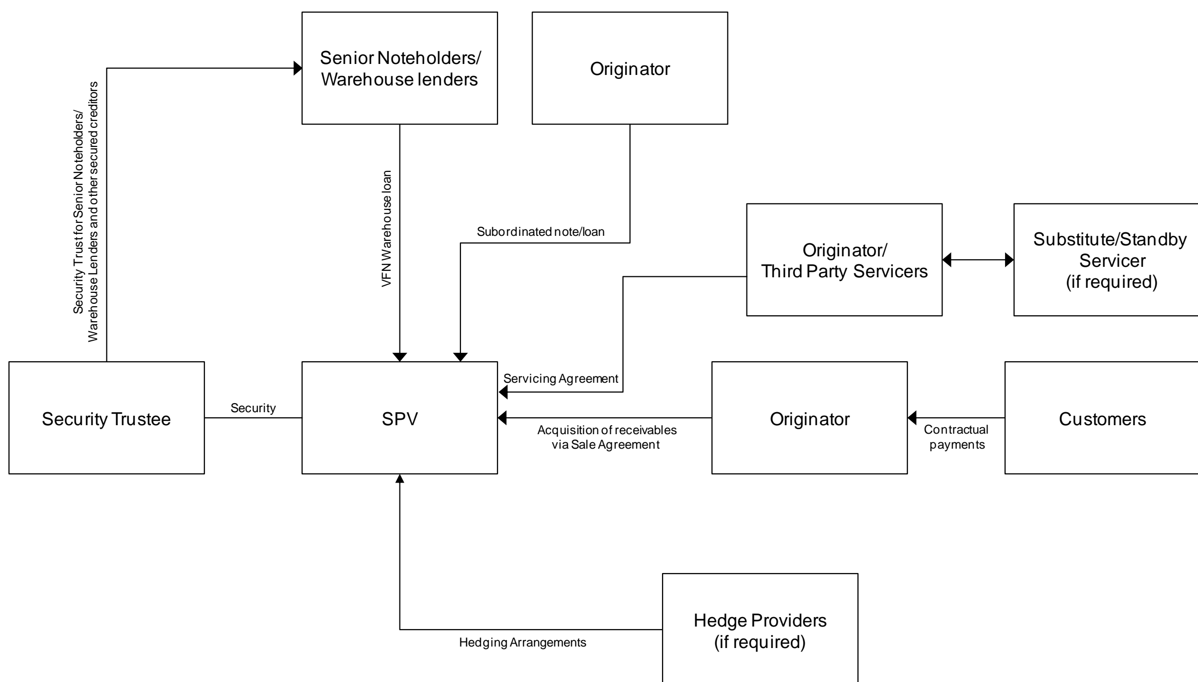
In this briefing, Clifford Chance looks further at this third category of warehouse financing as a funding tool, as well as the key issues for both originators and lenders to consider when implementing such financing arrangements. Important considerations are set out where a rating is sought for any type of warehousing, where additional creativity may be needed to preserve the flexibility of such warehouse transactions in light of rating agency requirements.

Warehouse Funding – Typical Structure

In terms of structure, securitised warehouse funding is traditionally categorised as funding provided by one or a small number of lenders on a limited recourse basis to a special purpose vehicle (SPV) and secured on a portfolio of assets acquired by the SPV from the originator. The funding may take the form of a loan or, more commonly in newer structures, a variable funding note (VFN). Moreover, the lenders will typically

only fund a proportion of the assets in the portfolio, with the originator itself funding the remainder via a subordinated loan or note.

Simplified Warehouse Structure



Key Points in Warehouse Structures

Flexible funding for originations

For a first time originator accessing the public market, the transaction will often be structured as a "stand-alone", as opposed to something more complex such as a multiple-issuance platform or a master trust. This is particularly likely where regular issuances of securities on the public markets are not contemplated. In the case of public RMBS transactions that are structured on a stand-alone basis, the portfolio of assets acquired by the issuing SPV on closing of the transaction is typically static. By comparison, where origination warehouse financing is used, more flexibility is often built in by permitting the SPV borrower to use cash received upon repayment of the portfolio assets to purchase new assets (as opposed to repaying the senior lenders) during a designated "revolving period". Structures where the lenders fund the SPV borrower via the VFN mechanic may also permit the SPV borrower to increase the portfolio size by issuing new notes or increasing the note principal amount, in order to purchase new assets from the originator, up to an agreed facility limit. Likewise, the VFN mechanic typically permits the SPV borrower flexibility to repay notes and reduce the size of the portfolio at any time in order to better fit the changing funding requirements of the originator.

Warehousing transactions also commonly include a simple mechanic for the lenders, the SPV and the originator to increase the facility limit. A key point for lenders therefore, is the extent to which they are exposed to the quality of the portfolio which, as noted above, may change over time. Eligibility criteria for new assets to be sold by the originator into the portfolio will need to be discussed and agreed, as will the representations and

warranties to be given by the originator in respect of the assets. These are frequently more bespoke and less standardised than the asset warranty package included in public transactions. Trigger events signalling the end of the revolving period (and following which the transaction must commence amortisation and the repayment of the senior lenders) will also be an important negotiation point given the potential impact of any termination of the revolving period on an originator's ability to fund the origination of new assets.

For originators, the price for such flexible funding from lenders may be the requirement to comply with specifically negotiated reporting requirements in respect of the asset portfolio, which may differ from that which is generally required to be provided to the wider investor base in public transactions. Lenders are often permitted to conduct audit checks at the relevant originator's premises and to undertake checks on compliance with asset warranties.

Lenders may also seek to embed within the transaction further controls over the relevant originator's origination, credit and collection policies to prevent any potential drift toward riskier lending practices. This may be particularly relevant where the borrower is a start-up or an originator with a limited trading history in the relevant asset class.

Rated warehouse structures

Increasingly, both lenders and originators are looking to obtain credit ratings for warehouse transactions. This brings its own challenges, as the flexibility of warehouse structures must then be balanced with the requirements of the rating agencies. On the other hand, the better regulatory capital treatment certain European lenders will receive in respect of a rated loan or note is an important consideration, not least because it can then translate into lower borrowing costs for the relevant originator.

Important considerations relevant to the ratings process include:

- Issuer corporate structure

Whereas the majority of public transactions use an orphan SPV issuer, which is not part of the originator's corporate group, there is more fluidity in warehousing transactions, particularly in the case of new start-ups or where start-up capital has been provided by means of private equity funding.

In such cases, it may be preferable from a corporate perspective to establish the borrowing SPV as a group company and on the balance sheet of the originator group (depending on tax and other drivers this may be in a different jurisdiction to the originator group). Where the intention is for the warehouse facility to be rated, a key point of analysis for a non-orphan SPV will be the extent to which the vehicle will be immune from any insolvency of the corporate group as well as the extent to which secondary liabilities (e.g. tax) of the corporate group, may become liabilities of the borrowing SPV with a corresponding impact on any repayment to the warehouse lenders. The answer to this question will depend very much on the legal analysis in the jurisdictions where the borrowing SPV and originator are based.

In the UK, structural mitigants will typically be needed to ensure an adequate level of comfort is provided to the rating agencies that the borrowing SPV will not be liable for any secondary tax (including VAT) liabilities that might arise where the SPV is part of the originator group. Likewise, pensions liabilities of the originator (if applicable) will need to be analysed and (where appropriate) addressed in each transaction.

- Recourse to the Originator

Due to the bespoke nature of warehouse arrangements, certain events of default or termination rights may be included in the financing documentation that relate to the performance of the originator or servicing entity (e.g. an event of default may be included in respect of the insolvency of the originator or the default by the originator in any of its material obligations). These would be unusual in a public transaction, where there would typically be a strong focus on disentangling the credit of the SPV from that of the originator. For the same reason, these types of provision may need to be considered carefully in rated deals in order to allay any concerns of the rating agencies.

- Repayment date mismatch

Where the rating obtained is based on the ultimate payment of principal, the rating agencies will expect the final repayment date to be a short period after the last maturity date of the assets in the portfolio. However, many warehouse transactions are structured as a 2-3 year transaction on the basis that the lenders will exit the transaction after that time and the assets refinanced in a public term deal or otherwise.

Where the expected repayment date of a warehouse facility is before the final maturity date of the assets, as may be the case for long-dated assets such as mortgage loans, the borrower SPV's repayment obligation will need to be carefully formulated in

order to mitigate any rating agency concerns that it could trigger a fire sale of the assets. One way of addressing this issue is to permit the lenders (or require the originator) to conduct an orderly disposal of the portfolio if repayment has not occurred by the expected repayment date (as opposed constructing the repayment obligation as a "hard" repayment date).

- Funding mechanics

As noted above, senior lenders will only fund a portion of the assets acquired by the SPV borrower from the originator, with the remainder financed by subordinated lending from the originator or, in some cases, mezzanine lending from another lender group. The calculations that determine the proportion of total assets held by the SPV that are funded by the senior lenders at any time may therefore be complex. In a rated transaction, such calculations may need to accord with the relevant rating agency's own models to ensure the senior funding can achieve the required rating.

- Operational Risk

Notwithstanding the extra control that lenders often have in warehouse transactions (as compared with public deals), the rating agencies will need comfort that the transaction (and, in particular, the servicing and cash management function) can continue and that scheduled interest and principal can be paid by the borrower despite any originator, servicer or cash manager default or insolvency. As such, the back-up servicing and cash management mechanics familiar to investors from public transactions will often be replicated in some form in rated warehouse transactions, including the use of "warm" back-up counterparties ready to take over running of servicing or cash management functions at short notice should this be necessary.

- Other considerations

Outside of legal structure, other considerations may affect the ability to obtain a rating for a warehouse facility, including the absence of historic performance information for the assets in the portfolio. The requirement that at least some information on the transaction and originator is made publicly available as a result of the rating process may also dissuade certain originators.

Regulatory and tax considerations

As noted above, warehouse arrangements regularly constitute "securitisations" for EU regulatory purposes. Indeed, as mentioned above, in some cases the transactions are deliberately structured to be rated securitisations for regulatory purposes. This means lenders and originators alike will need to be mindful of their retention obligations under the relevant EU regulations, including under Regulation (EU) No 575/2013 (the Capital Requirements Regulation) or, depending on the nature of the lender, Regulation (EU) No 231/2013 (the AIFM Regulation) or the Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II). In particular, originators should be aware of the requirement to retain a material net economic interest of not less than 5 per cent. in the transaction for the life of the transaction may apply, as it would in respect of a public securitisation.

In addition, Regulation (EU) No 1060/2009 (the Credit Rating Agencies Regulation) may also apply, though the specific obligation imposed under the Credit Rating Agencies Regulation will differ depending on whether a full public rating or alternatively, a private rating is sought. Where a public rating is sought in respect of the transaction, it is likely that a second rating will be required to be obtained. The disclosure obligations under the Credit Rating Agencies Regulation should also be carefully considered along with the transparency requirements contained within the Securitisation Regulation that has been proposed by the EU Commission.

In terms of structuring the transaction, examination will need to be made of the location and status of the lenders and of the SPV borrower as well as the location of assets, in order to determine which tax risks arise. Analysis of potential tax leakage will focus on whether any stamp or transfer taxes are assessed in the transaction, the VAT treatment in respect of any services provided, whether withholding tax arises on any deal cashflows, secondary (as to which, see above) tax liabilities and transfer pricing if the borrower SPV is an originator group company and, finally, the corporation tax treatment of the SPV.

In relation to the latter, it is possible to structure a UK warehousing SPV as a "securitisation company" as defined in the Taxation of Securitisation Companies Regulations 2006 (SI 2006/3296) meaning such SPV will be subject to corporation tax solely on its retained profit amount stipulated in the payments waterfall in the transaction. Withholding tax risk can be mitigated if the warehouse lenders

are treaty passport holders or, where the deal timeline permits, by applying for treaty clearance. Alternatively, the listing of the notes, most commonly on a an exchange other than an EU regulated market, such as the Channel Islands Stock Exchange, may address withholding risk in certain scenarios, in which case adjustments may need to be made to the finance documentation to ensure a smooth listing process.

Conclusion

Where execution risk exists in respect of any contemplated public transaction, lenders and originators (non-bank originators in particular) alike are likely to continue to look to securitised warehousing as an important financing channel. Whereas some originators may view warehousing structures as temporary, with a view to eventual refinancing through the public market, for some originators the private and flexible nature of warehouse funding may be a better fit with their corporate strategy over the long term without any need or desire to refinance such funding through the public market.

The development of this market is largely driven by lender appetite, the term of financing as well as required liquidity, all of which will factor into lenders decisions as to what type of warehousing they are willing to put in place. Where lenders see such financing as more short-term, a more liquid funding instrument may be preferable and certainly there is a developing trend within the market towards more pre-placed transactions using a public ABS structure. Hence the line between "private" warehousing and "public" transactions is some ways becoming less and less defined.

In the case of longer term origination warehouse structures, the ability to obtain a rating is clearly beneficial to lenders because it allows them to reduce regulatory capital costs. We therefore expect more warehouses to be rated going forward, meaning the warehousing structures used will continue to adapt and adjust in order to address the points discussed above.

PUBLICLY RATED UK WAREHOUSE TRANSACTIONS

Transaction Name	Asset Type
Optimum One S.Á R.L (2016)	Second lien mortgage loans
Startline Auto Receivables Limited (2016)	Auto leases
Charles Street Conduit Asset Backed Securitisation 1 Limited (2015)	Mortgage loans
Mortar No. 1 Limited (2015)	Mortgage loans
Paragon Fifth Funding Limited (2012)	Buy-to-let loans

Authors

Kevin Ingram
Partner

T: +44 20 7006 2416
E: kevin.ingram
@cliffordchance.com

Maggie Zhao
Partner

T: +44 20 7006 2939
E: maggie.zhao
@cliffordchance.com

Andrew Bryan
Senior PSL

T: +44 20 7006 2829
E: andrew.bryan
@cliffordchance.com

Thomas Picton
Senior Associate

T: +44 20 7006 4991
E: thomas.picton
@cliffordchance.com

Contacts

Clare Burgess
Partner

E: clare.burgess
@cliffordchance.com

Stephen Curtis
Partner

E: steve.curtis
@cliffordchance.com

Andrew Forryan
Partner

E: andrew.forryan
@cliffordchance.com

Emma Matebalavu
Partner

E: emma.matebalavu
@cliffordchance.com

Simeon Radcliff
Partner

E: simeon.radcliff
@cliffordchance.com

Christopher Walsh
Partner

E: christopher.walsh
@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance 2016

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Casablanca ■ Doha ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Istanbul ■ Jakarta* ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Perth ■ Prague ■ Riyadh ■ Rome ■ São Paulo ■ Seoul ■ Shanghai ■ Singapore ■ Sydney ■ Tokyo ■ Warsaw ■ Washington, D.C.

*Linda Widyati & Partners in association with Clifford Chance.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.