

# Finance Company Limited

## A Case Study in Asset-Backed Securities<sup>1</sup>

An Irish finance company, Finance Company Limited, has EUR 500 million of automobile hire purchase receivables that are currently financed by bank borrowing. Because the finance company is not a top credit, it does not have access to the public debt market on favorable terms. Also, because its balance sheet is debt-heavy, FCL cannot raise additional funds for expansion without issuing new equity.

At the same time, certain institutional investors in Ireland are suffering a shortage of high-quality paper with attractive returns.

Bank of Blarney proposes to securitize a substantial portion of FCL's HP receivables. The receivables will be transferred to a newly formed company that will issue asset-backed securities. The securities will be structured in such a way as to obtain a top rating from RAI, the Rating Agency Ireland. The text of a letter from RAI has been attached as Appendix 1.

Your task is to answer these questions for the issuer:

- (1) Explain precisely the steps in structuring such an ABS
- (2) Evaluate the pay-through vs the pass-through structure for a situation like this
- (3) Identify the benefits and disadvantages to the issuer.
- (4) What additional information would you need?

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# Characteristics of the assets

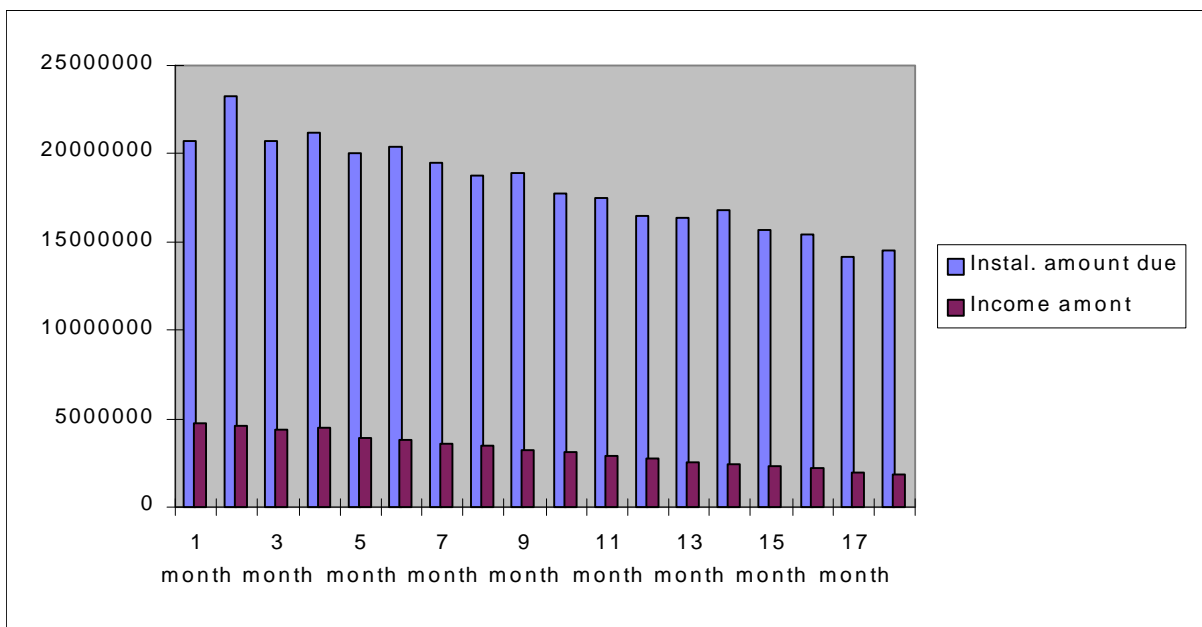
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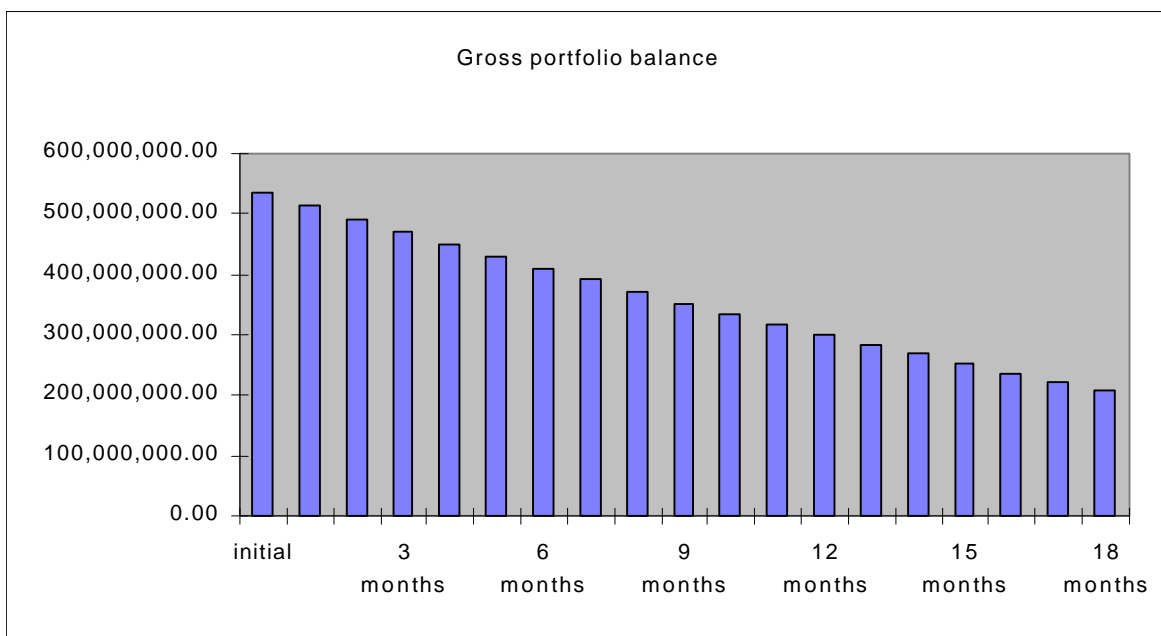
## Total Portfolio

As of January, 1999, FCL HP receivables amount to EUR 555,458,000.

## Schedule of Payments

The following charts show the scheduled principal and interest payments, and outstanding balances, month-by-month for the next 18 months.





### **Portfolio Diversification of Collateral**

Loans are broken down into four main categories: commercial vehicles (representing 22% of the total amount), heavy machinery and equipment (24%), passenger cars (31%), and consumer goods (21%). Commercial vehicles and passenger cars represent the largest number of loans (respectively, 29% and 48% of the total).

### **Geographical and Borrower Diversification**

Loans are broken down into 15 branches. The largest are Dublin (40% of the total loan amount), Killarney (25%), Westover (19%) and Eastover (11%). The composition of borrowers is: companies (60% of the total amount), businessmen (17%), firms (12%) and some 25 other categories sharing the remainder. No loans represent more than 0.15% of the portfolio amount.

### **Loan Size**

Commercial vehicles and passenger cars' average loan size are EUR 56,000 and EUR 21,000 respectively. Machinery and equipment have the highest average loan size (EUR 112,000) followed by consumer goods loans with an average size of EUR 52,000.

### **Interest Rates**

Rates range from 10.10% to 19.7%. The weighted average rate is 12.6%.

### **Delinquencies**

Overdue amounts as a percentage of total balances outstanding are: 6.3% for West Ireland and 7.8% for East Ireland.

### **Defaults and Recoveries**

Defaults comprise less than 0.7% of outstanding amounts, of which approximately 40% is recovered within 1.5 years.

**History of the Portfolio and Sensitivity to Economic Conditions**

The evolution of the portfolio over time and its correlation with general economic factors is contained in a separate table.

# Sample Term Sheet

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The following is a sample "term sheet" showing a summary of the terms of a typical asset-backed issue that might be done in Ireland.

## *FCL 1995-A Asset Backed Securities*

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Issuer	FCL 1995-A, a special-purpose trust
Seller	Finance Company Limited
Servicer	Finance Company Limited
Securities offered	EUR200 million auto hire-purchase receivable asset-backed certificates Series 1995-A due 1 June 1999.
Structure type	Pass-through certificates issued by a Trust evidencing claims on assets held by the Trust
Legal structure	Sale of assets from FCL to the Trust
Collateral assets	Retail automobile hire-purchase contracts originated
Trustee	Price Waterhouse
Lead underwriter	Bank of Blarney (Ireland) Limited
Data on the asset pool	The pool of assets held by the Trust consists of EUR220 million of HP receivables Weighted-average annual contract rate: 12.6% New autos: 87% Geographic distribution: Greater Dublin 53%, Killarney 16%, Westover area 11%, Eastover area 9%, Other 11% Weighted-average remaining maturity: 29 months Loss and delinquency experience: below average (see table)
Credit enhancement	A 5% limited guaranty by FCL to cover losses.
Rating	AAA rating by Rating Agency Ireland

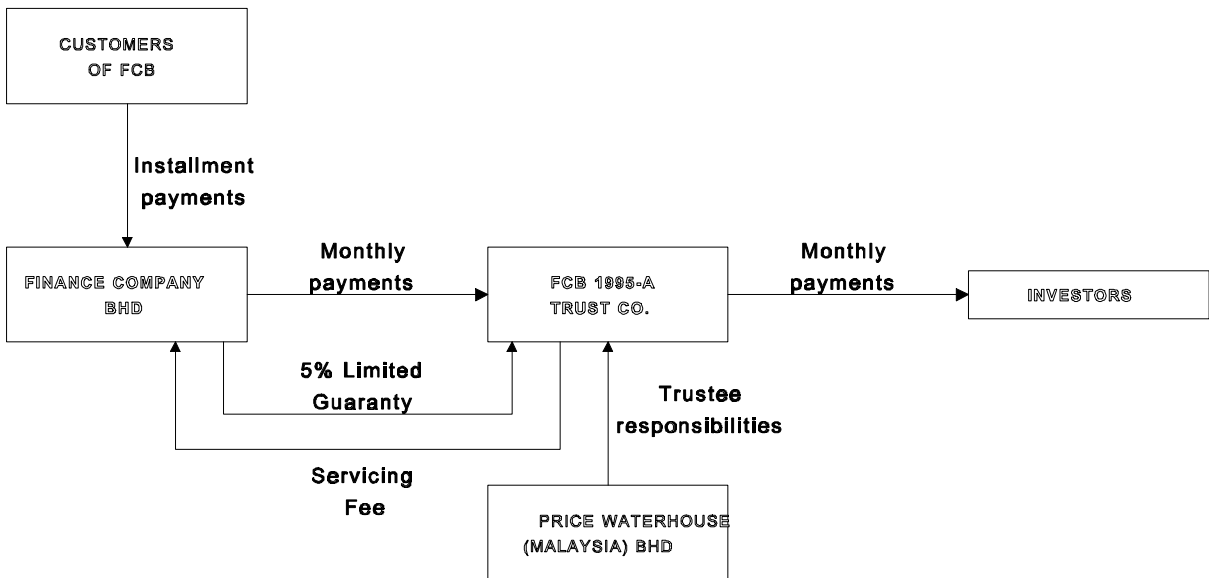
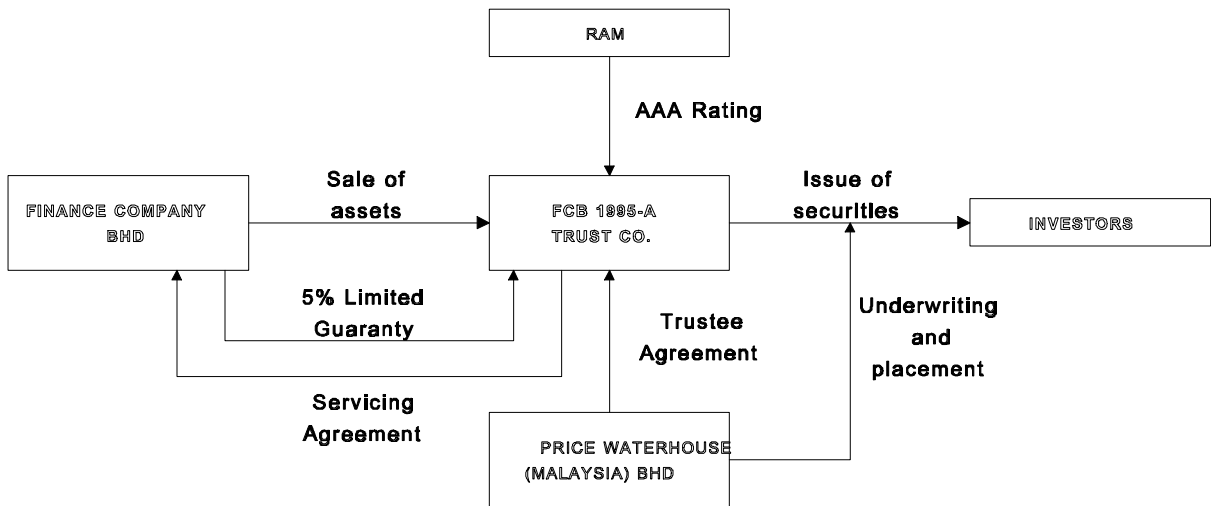
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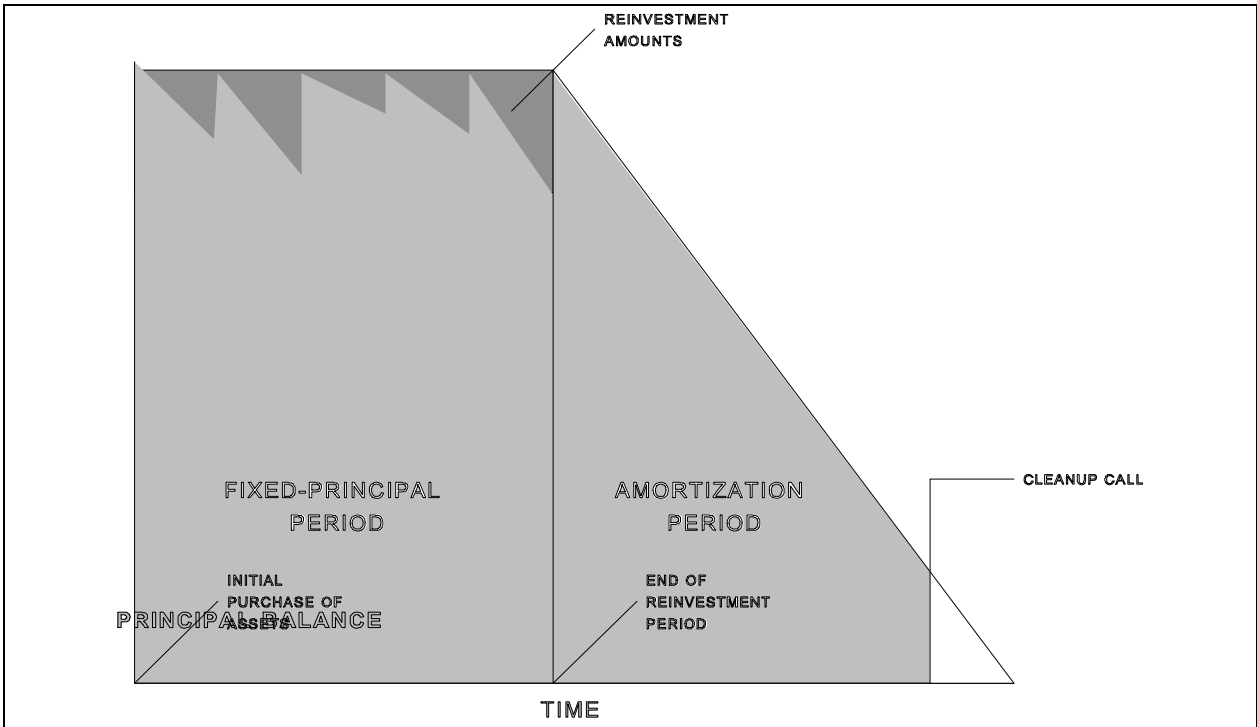
# Illustration of the Structure

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In the following diagrams, a pass-through structure is used to show how Bank of Blarney could arrange for a new Private Debt Security be issued by a Special Purpose Vehicle (SPV) set up to buy the hire purchase receivables.

- Figure 3 shows the initial stage when the assets are sold to the SPV, called FCL 1995-A.
- Figure 4 illustrates the ongoing flow of cash payments.
- Figure 5 shows how the total level of assets is kept at the ABS principal amount, plus a cushion to protect investors against default risk, by replenishment of the pool until the end of 2 years, after which the debt is paid down in accordance with the paydown of HP contracts in the pool.







## Appendix 1. Rating Agency Ireland information requirements for Asset-Backed Securities

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In evaluating ABS issues, RAI will likely be focusing on three main areas of analysis, namely, the legal structure, credit risk and cash flow structure of the proposed ABS issue. We enclose below our preliminary requirements on the subject which we hope would be useful to you.

### *Legal Structure*

- Information on parties involved in the ABS issuance, namely, the originator(s), servicer, merchant bank, lawyers, accountants, trustees, credit enhancer, liquidity banks.
- Proposed legal structure and documentation e.g., type of assets to be securitised, senior/subordination features; pass-throughs/pay-throughs, any recourse provisions, corporation/trust, over-collateralisations, other risks and claims structure, etc.
- Legal and accounting opinions (and subsequently regulator's opinion) on the characterization of the transferred assets i.e., a "true sale" or "pledge". The legal opinion should also extend to opinions on the possible impact of the issuer's bankruptcy on the securitised assets, liability to stamp duty and sales tax.
- Tax opinions on how to SPV would be taxed and whether investors' investment in the ABS represent debt or equity to the SPV.

### *Credit Risk*

- 10-year industry statistics/analysis on the assets to be securitised e.g., if auto-loans then motor-vehicles HP in Ireland (new vs. used cars if possible), yield statistics of assets, non-performing loans, ageing/delinquencies, customer demographics and repossession rate.
- Summarized 10-year historical records/statistics on the originator's motor-vehicles HP portfolio, focusing on portfolio performance and characteristics including the following:
  - growth
  - yield
  - underwriting standards and loan terms/maturity
  - recourse provisions to motor-vehicle dealers
  - ageing/delinquencies rate
  - collection and recovery procedures (including repossession rate)
  - customer profile/demographics
  - new versus used cars
  - prepayment history
- Information on the intended pool selection process including the following:
  - whether new or used cars
  - maturity period
  - seasoning
  - loan to value of cars
  - whether insured, types of policy, insure amount
  - delinquency factor
  - any previous extension and rewrites
  - interest rate

### *Cash Flow Structure*

- Cash flow mechanics/control
- Timing of receipts and payments
- Liquidity support