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Favourable capital ruling fuels European demand for US 'stranded cost' ABS

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The weighting game

A 20% risk weighting and attractive spreads versus comparably-treated securities is causing some UK and other European bank buyers to take a fresh look at US dollar-denominated "utility stranded cost" securitisations. A recent deal from Texas is the first such issue to achieve a 20% weighting. Another US$10bn of similar transactions is on the way and might also benefit from the favourable capital treatment.

Some fairly unique US domestic bond deals are finding their way into the hands of BIS constricted European investors who have benefited from favourable risk weightings on the securities while realising higher yields than on competing products. The most recent instance of this was a "utility stranded cost" securitisation from **TXU Electric Delivery Transition Bond Company**, an entity created by TXU, a Texas utility, which was completed late last month (see IFR1535 p43).

Although the deal was not actively marketed in Europe, one UK bank investor that purchased the bonds received a coveted 20% risk weighting on the security from the FSA in an individual ruling, according to observers familiar with the matter. The FSA declined to comment on the ruling.

European banks are typically burdened with a 100% risk weighting on asset-backed securities issued by corporates, while US banks enjoy a 20% weighting. The issuer was able to break new ground, however, by tracing the payer of last resort on the TXU bond to state government entities.

Saber Partners, the adviser to the Texas Public Utility Commission on the bond sale, was inspired to seek the lower risk weighting by the mammoth US$10bn taxable municipal bond offering completed last year by the **State of Illinois**. Illinois extensively marketed its bond offering in Europe, and placed roughly one-third of that 20% risk weighted issue with Europeans, clearly demonstrating the region's appetite for such securities.

As the TXU deal was being assembled, Saber was attempting to convince the FSA that it should receive favourable capital treatment. "The bankers advised us that there was tremendous unmet demand for 20% risk weighted assets overseas, and to get lower ratepayer costs – especially with the anticipated US$4bn–$6bn in supply coming from Texas – we needed to expand demand and open up this new market," said Joseph Fichera, chief executive of the financial advisory firm. "If you expect investors to give up nominal yield, you need to give them something in return – and this was to get regulators and underwriters and investors to correctly understand the true nature of the security."

By achieving the lower risk weighting, European banks are able to compare these securities to agencies and supranationals that receive the same capital treatment, rather than other asset-backed securities or corporates, which are 100% weighted. The TXU deal offered a roughly 10bp pick-up over US agencies, which already trade quite cheaply at an asset-swapped spread of Libor plus 4bp in 10-years.

Structural nuances

Stranded cost securitisations, found only in the US, are an attempt by lawmakers to level the playing field among utilities, as they reorganise the electricity business into competitive markets from regulated monopolies.

Utilities that made poor investments under the regulated regime, such as in now-outdated nuclear plants, are being offered an opportunity to recover those investments by placing charges on the electric bills of customers in their service areas. These charges, known as transition charges, represent the first dollars collected from ratepayers, and these back the stranded cost securitisations.

In certain aspects, however, the TXU securitisation was different from other stranded cost deals, enabling it to achieve the favourable capital treatment. Like other stranded cost issues, it featured a true-up mechanism – whereby if some utility customers fail to pay their electricity bills, the transition charge is recalculated so that those ratepayers who do pay make up for any shortfall. Unlike other deals, however, it has no limit on the amount that the transition charge can be raised.

Taking this a step further, the prospectus contained specific language identifying the State of Texas as one of the ratepayers backing the bond, and therefore noted that the State would be a payer of last resort. Additionally, the State specifically pledged not to take any action that would impair the issuer's rights to collect the charges and enforce the true-up mechanism, a very unusual move. A breach of this pledge would result in bondholders having a claim against the State. Therefore, even if all ratepayers in the private sector defaulted – obviously an extreme case – the true-up would be raised to the point where the State would make up the entire difference.

It remains to be seen whether other issuers will jump through the hoops that TXU did to achieve a 20% risk weighting in Europe, but if they sense it would generate demand of any significance, it is very possible that they would.

One significant European investor said that these types of deals are very robust and he would welcome the opportunity to extend his portfolio's exposure to these types of transactions as he has only one such issue on his books. The last time there was a significant amount of stranded risk paper in Europe, Spain was the source way back in 1995/96 and the sovereign's guarantee resulted in a zero risk weighting.

Roughly US$10bn of stranded cost securitisations are expected to emerge from the US during the next 12 to 18 months. Although this was TXU's final deal, three other Texas utilities are to issue another US$4bn–$6bn worth of these bonds, while California utilities are looking to sell up to US$3bn within that period. Smaller deals in the US$300m to $500m range are also expected from utilities in Wisconsin, Michigan, New Jersey and Vermont.

Jeff French

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