Losing the advantages of floating charges

In Real Estate Finance, it is quite common to finance assets that will generate sufficient rental income to pay off the interest of the loan. The principal is to be repaid when the asset is sold to the next party, preferably before the maturity of the loan. Looking at the way of securitizing the asset and the standard use of a rental account we can see that this is an example of positive impacts of floating charges being blocked by the necessity of fixed security to secure the debt. Please find below the standard way of incorporating rental accounts and the many positive opportunities inherent to floating charge but counteracted by the need for fixed security.

Background Upon finalizing the LMA loan agreement for Asset finance transactions, it is required to open several bank accounts, including a deposit account and rental account. The (future) rental income under the loan agreement is to be directed to the appointed bank account in question that is to be opened at one of the Lenders, usually the Lender that has also taken on the role as Security Agent i.e referred to as the rental account. The rental account will be monitored throughout the tenor of the loan and will be used for the repayment of interest on the loan in general (of course exceptions can be made though). Remarkably, the rental account is not blocked and the Borrower (or Company) can freely use the rental account for other payments that related to the general course of business, next to the fact that the rental income still needs to be received on the rental account. Automatic charges from the account are not obligatory.

Introduction The following characteristics of floating charges (the rental account income flow) are encountered: the flows of the account are pledged, usually first rank and pari passu, but do not have the advantage and/or disadvantage of a secured asset (i.e. fixed charge), which is behind the floating charge. The secured asset in this case is the financed assets that generates the income. The floating charge is to be linked to the fixed charge to secured repayment of debt. The assets is to be sold before the maturity of the loan but in the meantime many more risks can be encountered: renters that are leaving (reduction of income flow), the asset not being sold in time or the asset being sold below the value of the outstanding debt. Note also that the change in value on the asset may vary and this will be in line with the provided security on the asset in question.

Business case The following problem arises: as the floating charge needs is always linked to a fixed charge, the advantages of the floating charge gets limited or even eliminated. Upsides of floating charges are:

(1) The security behind the floating charge gives the Borrow the freedom to use the asset more freely in the ordinary course of business than as if the asset was secured i.e. it allows the Borrower unrestricted use of the asset.

(2) The security provider would be able to provide floating charge before the asset exists (f.i. rent being paid up front in the form of security),
(3) Floating charges are another type of security which opens up financing opportunities for those companies not rich in physical assets, and lastly

(4) It gives the opportunity to control the business in case of sell out without having to enforce selling the actual assets of the business (going concern is still there).

However by linking it to a fixed assets under the same loan agreement the following is happening:

(1) The secured asset (fixed charge) is no longer so free to be used for the Borrower. The fixed security will be subject to a number of conditions f.i. purpose of the asset ,what would not exist for floating charges and is not free to be replaced or disposed of (without repaying the debt).

(2) The Lender will no longer allow for a security on non-existing assets, as this is not allowed under fixed charges

(3) Companies that can only provide floating charges as security will not be able to satisfy Lenders as the link to fixed charges is not possible. These will have more trouble in providing security for additional bank debt.

(4) The secured asset is high up on the charge when liquidated (1st ranking), the floating charge comes behind, i.e. all other creditors come first in case of bankruptcy. This way, the company holding the asset will no longer be sold under the going concern, but most likely has to be liquidated in order to pay off the debt.

Conclusion: As a result, though use is made in asset financing of floating charges expecting to benefit from its advantages, it seems that all the advantages towards the Borrower and in some cases, also the Lenders, can be easily counteracted by means of the connection with fixed charges or a fixed security. This is especially unfortunate for those companies lacking physical assets that can provide as security when attracting additional funding through (bank) debt. The question also arises if floating charges are to be perceived as a nice to have instead of being perceived by a valuable security as the use of a standalone floating charges is usually not preferred by Lenders.

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