Fundamentals of Asset-Backed Securities Markets

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Securitisation

Securitisation (“structured finance”): the process by which (relatively) homogeneous, but illiquid, assets are pooled and repackaged, with security interests representing claims to the incoming cash flows and other economic benefits generated by the loan pool sold as securities to third-party investors

- single-class offering: all investors receive a *pro rata* interest in the incoming revenues from the asset pool
- multiclass offering: two or more classes or *tranches* are granted different (and in some cases uncertain) claims, each with its own pay-out and risk characteristics

Securitisation--basic forms

- Securitisation usually refers to (“off-balance sheet”) transactions in which the underlying assets are either removed from the sponsor’s balance sheet, or never appear there after origination
- in some jurisdictions, however, originators can achieve similar objectives by “ring-fencing” or segregating the assets, which for accounting purposes remain on balance sheet.
- On-balance sheet securitisation: specialised lenders fund themselves long-term by issuing bonds against collateral (mostly mortgages)

Trends in asset-backed securities markets

ABS markets continue to evolve in terms of asset classes and structures.

- blurring distinction between structured finance and corporate finance
- increased use of derivatives and securitisation in the same transaction
- increased use of securitisation to convert insurance risk into capital market risk
- on the ratings front, increase in the number of downgrades
- changes in the legal and regulatory environment

Inside ABS Transactions

Types of assets:

- feasibility: relatively identifiable, though not necessarily low, default risk
- requires extensive historical databases that record the loss experience of many comparable assets
- in the absence of adequate information on credit performance, loss probability distributions for different types of borrowers, businesses, or loans cannot be reliably estimated
- loan originators who specialise in evaluating loan proposals can usually distinguish better credit risks from poorer ones, but this assessment of quality is often subjective and somewhat difficult to quantify

Inside ABS Transactions (cont.)

rational investors would add a sizeable discount to the implicit price at which the underlying assets are purchased to compensate for the increased uncertainty regarding the credit risk of the assets in pool

issuer can reduce the size of the discount by

- securing the assets with collateral that can be valued with relative certainty, or
- including substantial credit enhancements in the securitisation

but high levels of credit enhancement add significant costs to the securitisation of an asset pool and can render the transaction uneconomical

Inside ABS transactions (cont.)

Consequently, securitisation has often been used for assets for which the costs of acquiring and distributing information to credit rating agencies and investors about loans and borrowers are low

- standardised loan underwriting criteria and advances in information technology have made it easier to estimate default probabilities and payment patterns under a variety of economic conditions.
- pooling such assets into large homogeneous groups facilitates an actuarial analysis of their risks, which enables rating agencies and, in some cases, third-party credit enhancers to review and validate the originator's initial credit underwriting decisions.

Inside ABS transactions (cont.)

For example, issuers of mortgage-backed securities in the US add some supplemental guarantees, but most of the assurance is inherent in the underlying collateral and the ability of mortgage insurers to guarantee the ultimate payment of

But, recent years have witnessed the emergence of a variety of new asset classes and structures, an expansion of the investor base, and a marked increase in cross-border activity

C&I loans at banks, once deemed to difficult to securitise owing to their lack of uniformity in terms, structures and prepayment patterns have been the fastest growing segment of the ABS collateral pool.

Structure of ABS

Sponsor, trustee, servicer:

- typical structured financing begins with a pooling and servicing agreement among a sponsor, which often is (but need not be) the originator of the assets, a servicer (primary administrator), and a trustee.
- The servicing function is often carried out by the sponsor or an affiliate of the sponsor, but may be performed by a third party. Tasks vary depending on the type of assets involved, including collecting on delinquent loans & recovering on defaulted loans (all asset types).
- Trustees generally are commercial banks that are not affiliated with the originator/sponsor or with other parties to the transaction. The trustee ensures the orderly payment of interest and final payment of principal

Structure of ABS (cont.)

The ABS agreement establishes the legal entity that will be the issuer of the securities and governs the transfer of the assets from the originator to the issuer (and ultimately to the trustee).

- The issuer is often a trust or “special purpose vehicle” (SPV) whose only business activity is to acquire and hold the assets, and issue securities backed by the assets.
- The legal entity or SPV used by sponsors depends on the type of assets, the structure of the securities to be sold, and the laws governing securitisation in the country of issuance

Special purpose vehicles

An SPV may take the form of a trust, a special limited partnership, or a special purpose corporation.

- These entities exist to facilitate different forms of economic activity and, thus, have specific accounting and tax rules governing their operations
- despite fundamental differences in the types of economic activity for which a given SPV may be eligible (without incurring tax at the entity level), the primary objective of all of them is to facilitate the indirect investment in the assets by parties other than the originator
- where local laws do not provide for the establishment of trusts, sponsors have used off-shore vehicles

Separation of the assets from the originator

Securitisation relies to varying degrees on the separation of the assets from the originator

- asset pool is pre-specified, so investors are not exposed to other types of risks that would be associated with a direct credit exposure to the originator, such as geographic concentrations
- SPV must be insulated from any possible bankruptcy of the originator/sponsor
- important that the transfer of the assets from the sponsor to the SPV constitute a “true sale” and not a secured borrowing
- otherwise, if the sponsor became subject to bankruptcy or reorganisation proceedings, all cash flows arising from the underlying assets would become subject to the insolvency proceedings

Separation of the assets from the originator

When the assets are fully separate from the sponsor, the rating agencies can focus on the historical performance of the assets, the quality of servicing, etc. without taking into account the sponsor's own credit quality.

- Enables senior tranches to be rated above the ratings assigned to the sponsor
- results in tighter and more consistent offering spreads

Credit enhancement

The placement of ABS with investors generally requires giving investors adequate protection against risk of default to eliminate the need for them to monitor collateral directly

- usually entails raising the credit rating of the securities relative to the lender's own rating or to what would be assigned to the underlying collateral
- if the assets can be appraised relatively easily at a sufficiently high rating, the ABS issue can be a less costly source of funds for the sponsor than a direct financing
- amount of credit enhancement needed depends on several factors, including rating agencies' views of the historical performance of the assets, the degree of diversification across obligors, industries, etc. and the structure of the transaction

Credit enhancement (cont.)

Two basic categories of credit enhancement:

- internal (e.g. over-collateralisation, recourse arrangements, senior-subordinated structures)
- external (e.g. irrevocable letters of credit or financial guaranty insurance from third parties with triple-A credit ratings). Rating agencies assume that the credit quality of the securitisation cannot be higher than that of the weakest link in its enhancement package. Thus, with external credit enhancements, the rating of the senior securities in an ABS issue is typically capped at the rating level of the third-party guarantor, regardless of the quality of the collateral.

Credit enhancement (cont.)

Various forms of credit enhancement are often used in combination and typically provide credit support equivalent to several multiples of the expected losses in the asset pool. But these all have costs.

- The level of payment support required is a key consideration.
- It is largely the value of the securities receiving the highest credit rating (and thus selling at the highest price) relative to the value of the total asset pool that determines the total proceeds from the securitisation and whether it makes economic sense for the sponsor to do the transaction.

Securitisation versus bank loans

A company in search of external funds has two primary choices: borrow from financial institutions or raise funds directly in the capital markets

- depository institutions must provide a buffer layer of capital that is subordinate to the claims of depositors and other providers of low-cost funds and typically endeavour to maintain capital cushions above the regulatory minimum
- this buffer layer is expensive
- thus, under normal market conditions, borrowers who raise money through the sale of securities have tended to face lower financing costs than borrowers whose credit is intermediated by banks

Securitisation versus bank loans(cont.)

- Provided the costs of issuing the securities are less than the differential between the interest rate paid on the securities and the loan equivalent

Banks have tended to specialise in financing activities that are difficult to assess and contain a large measure of subjectivity

- over the course of a long-term relationship, banks may acquire information that helps to attenuate the information problems associated with certain lending activities
- however, the costs of monitoring the borrowers are likely to be high

Securitisation versus bank loans (cont.)

- Securitisation has typically been used for loans whose credit risk is relatively easy to assess and for which indirect monitoring mechanisms are adequate
- Investors, in turn, have been willing to pay for the greater liquidity and credit transparency of securities over loans by accepting lower returns on securities than the equivalent loans would offer
- Lenders gain access to a broader base of investors, where different investor categories are attracted to different financial products, which can result in increased liquidity and a means of achieving balance-sheet diversity
- Assuming competitive markets, some of the benefits originators derive from securitisation may be passed through to borrowers in the form of lower funding costs

Benefits of Securitisation

Securitisation is a viable financing option only if the benefits of selling the assets exceed the costs

In general, success in securitisation depends on the ability to structure the transaction in such a way that the total costs of converting the asset pool into securities and distributing them to investors is less than the spread between the amount that borrowers pay on the loans and the yield that investors require on the securities.

Costs involved in off-balance sheet securitisations include fees for establishing a trust or SPV, underwriting fees, servicing fees, and may also include withholding taxes, stamp duties and other costs

Securitisation is a data intensive process and entails a great deal of administrative and legal work

Benefits of Securitisation (cont.)

Lenders:

- means of addressing asset quality problems
- access to funding at rates normally reserved for entities with superior credit ratings
- access to longer term funding (for low rated originators)
- access to international capital markets (for unrated originators or those with sub-investment grade ratings
- means of diversifying geographically or across sectors by passing along selected assets to third-party investors
- better match between the duration of assets and liabilities
- increased liquidity

Benefits of Securitisation (cont.)

Investors:

- ABS have enjoyed a favourable performance record over the past ten years with default rates that are a fraction of those experienced by similarly rated corporate securities
- combination of healthy, investment-grade credit ratings (for senior tranches) priced at attractive spreads to similarly rated benchmark securities
- ABS offer combinations of senior and subordinate tranches, each with distinct payment patterns and risk characteristics. They entail complex interest rate/credit risk combinations and trade-offs and, thus, have usually been acquired by relatively sophisticated investors who have developed the credit assessment skills necessary to evaluate the various alternatives.