Securitisation

Introduction

" The recent turmoil in credit markets has highlighted how securitisation has changed in only a few years from being a relatively niche market in the euro area to being a major force behind capital market developments". This growth in securitisation reflects the increased pace of financial innovation in the financial markets.

It is rational to say that this global trend of the growth in securitisation is a result of the advantages that are derived by the different parties engaged in the transaction. Securitisation has become an important tool for many companies and a key part of the global capital markets. However, while securitisation has benefited the financial system as a whole through enhancing its ability in performing its various functions, it has concurrently changed the underlying economics of the banking system, which brought consequences as those experienced in the 2007 financial crisis.

Whether the gains exceed the losses is a debatable issue in itself as some intellectuals believe that securitisation has " contributed to the development of a far more flexible, efficient, and resilient financial system than existed just a quarter-century ago", while others believe the opposite. The significance of securitisation has led to there has been talks by influential bodies about how securitisation can be regulated or changed as to maximise the benefits and minimize the costs.

In this essay, to answer the above question I will define securitisation, explain its mechanics and nature and lastly discuss its advantages and disadvantages for the different parties engaged in it and the financial system

as a whole. The scope of this essay is secondary securitisation, so the above will be discussed specifically to this type and not primary and tertiary.

Definition of Key Terms

Securitisation in general is the “ creation and issuance of debt securities, or bonds, whose payments of principal and interest derive from cash flows generated by separate pools of assets”.

There 2 types of securities that can be issued. When the securitised assets are mortgages, the securities issued are known as Mortgage -Backed Securities (MBS) and where it is other assets which are non-mortgage loans then Asset-backed securities (ABS) are issued. In the latter type, assets included are such as consumer loans, credit card receivables and car loans. These securities are marketable financial instruments, and tradable. In every securitisation transaction the capital markets are displacing the banks regardless of its type, whether primary secondary or tertiary, i. disintermediation. Secondary securitisation is Asset Backed. Bank of England defines this type as “ a transaction or scheme whereby the credit risk of an asset or a pool of assets such is transferred to an external undertaking (the securitisation special purpose vehicle or structure), which then transfers this credit risk onwards to investors in fixed-income securities known as asset backed securities issued by that undertaking. The investors in the securities may be either external investors or the institution that originated the underlying assets”.

Another way to look at this process is through Professor Llewellyn definition which explicitly high lightens the benefits. He defines secondary securitisation as ‘ the conversion of cash flows from a portfolio of assets into

negotiable instruments or assignable debts which are sold to investors, are secured on the underlying assets and carry a variety of credit enhancement". To clearly outline the pros and cons of the participants in the process, one needs to understand their roles as shown below in figure 1. Figure 1

How it Works

When a bank transforms a portfolio of loans that it is currently holding on the balance sheet into tradable securities issued by a bankruptcy-remote special purpose vehicle it follows a basic procedure as seen in the diagram. A number of customers borrow from the bank. They all have to payback regular interest and principal payments to the bank as agreed upon on the contract. Starting from the originator in this case the bank, it pools together a number of these loans (assets) and constructs a portfolio of which it sells to the special purpose vehicle SPV.

The SPV usually acquires the underlying assets from the originator in what is known as a true sale. It is critical that the transfer of assets from the originator to the SPV is legally viewed as a " true sale". This is because it gives the investors rights over the specific assets of the originator, such that the investors are not affected by the performance, or bankruptcy of the originator. This would obviously necessitate that the investors, or the SPV which is a conduit on behalf of the investors, has legally acquired the assets.

If it is not a true sale the investor will be vulnerable to claims against the asset originator in this case the bank. The SPV then issues asset – backed securities to investors which investors can them trade in the financial capital markets. Investors then buy these securities and the SPV receives the

regular interest and principal payments from the borrowers through the originator or servicer (if the bank does not retain the servicing function) who charge a certain fee. The SPV pays the originator for the portfolio in a lump sum rather than a stream of payments spread over time.

It is important to acknowledge that the bank continues to maintain the relationship with the customer and it does not have a duty to inform this about this process. The credit quality of the securities issued by the SPV is rated by a rating agency before being sold to investors. Also another important participant though missing in figure 1: 1, is a credit enhancer. This is either internally or externally done and it might take the form of " over – securitisation (placing a higher value of loan in the portfolio than the value of the sale), a third party guarantee or a guarantee from the seller".

This has the effect of limiting the risk to investors. The underwriter is usually an investment bank that serves as an intermediary between the issuer (SPV or the trust) and investors. The swap counterparty as seen in the diagram is normally involved to hedge the interest rate and currency risks on the pool and the trustee ensures that themoneyis transferred from the servicer to the SPV and that investors are paid in accordance with the promised priority. A crucial aspect of securitisation is the isolation of assets. After a true sale, the assets (collateral) are held by the SPV or equivalent.

This protects the seller (originator) from the risk of the assets and investor from the risks of the bank, because even if the bank goes bankrupt, the payments on the assets will continue to be made, so investors still receive the interest and principal payments. An SPV might be a completely independent entity or a subsidiary of the bank itself. In the crisis it was more

of the latter. However, for it to be a subsidiary it will only work if the SPV is bankruptcy remote, as explained earlier. This is where under company law the SPV is immune to the bankruptcy of the ank. This makes their risk entirely different and this is how credit risk isolation and shifting is possible. Also an SPV might become a Structured Investment Vehicle. Often the SPV has a higher credit rating (most secure a AAA rating) than the originator. The SPV performing the asset-backed securitization(s) also usually has a backup liquidity facility in place provided by a stand-by commitment from a syndicate (group) of banks. This facility protects the investors who purchase the commercial paper issued by the SPV as the assets are being purchased and pooled.

If for some reason the SPV cannot attract the same or new investors to roll over the commercial paper or there is insufficient cash flow generated by the pool to pay off maturing commercial paper then the SPV draws on the backup liquidity facility to pay off the investors and the bank group then become the owners of the assets held by the SPV (to either wait for the cash flow to improve or to liquidate the portfolio). Credit enhancements are required in order to receive higher debt ratings and thus improve marketability and financing costs.

The credit enhancement of a securitization can be achieved by dividing it into tranches and allowing some tranches be exposed first to any loss from defaulting / under-performing individual asset or group of assets first. In this manner, these front-line tranches almost function like an equity piece such that the investors in the other tranches (Mezzanine tranches) are satisfied first before the lower tranches. These lower-rated (first loss) tranches usually

receive a higher yield (due to their higher risk position) when the security is first structured in order to attract investors when first brought to market. . Advantages of secondary securitisation There are different aspects to the benefits of securitisation, the benefits derived by the issuer (bank) and those derived by the investor and the financial system as a whole. 2. 1 The issuer Secondary securitisation benefits the banks by helping them generate more funds but also by allowing them to manage their assets and liabilities, risk and also capital. * A source of funding Securitisation enables banks to change the illiquid portfolio of loans into liquid tradable securities. It makes loans marketable.

So the banks get funds immediately from selling the portfolio to the SPV. Also there being a secondary market for these securities in itself increases the attractiveness of investors to buy the securities meaning more funds. The funding source is also widened because as the risk are specific, asset – backed securities often appeal to investors who would not normally make funds available to banks by themselves. This source of funding may also be cheaper for the bank. This is because banks do not need to increase their interest rates to ‘ attract marginal deposits to fund their loan book’.

Also because the banks transfer the asset to the SPV they do not need to hold capital against the loans (assets) which is a cost, making this type of funding cheaper. Ultimately this means that it can offer lower interest rates to borrowers, which could have the effect of increasing the quantity of loans demanded. This cheapness is not always possible; it only depends on the nature of the risks of the portfolio after and before securitisation. * Asset and liability management The fact that securitisation allows banks to shift the

assets from their balance sheet allows them to change their asset composition on the sheet within a given total.

They can change the structure of their assets and ' reduce exposure to a particular loan category' by securitizing those loans which also helps in managing risks. It also provides the balance sheet with flexibility and facilitates diversification of the loan portfolio. * Risk management As the definition implies, securitisation allows banks to transfer and shift credit risk from their balance sheet to those who are willing and more able to absorb them. Hence this allows banks to manage their risk and limit their risks by selling those loans.

The transfer of risk allows banks to not hold any capital against the risks, so as earlier said reduces the cost of banking. It also allows them to manage interest rate risk. * Capital Management Due to the increasing competitive pressures, they cannot earn a sufficient return on the assets to service their capital base well. Securitisation saves them capital as explained earlier. * Other Banks can earn additional income by charging fees on originating loans that it does not intend to keep on its balance sheet.

Also banks still get to maintain their relationship with their customers and reduce the overall cost of intermediation by concentrating on their comparative advantages (originating loans).

The Investor

It gives investors the opportunity to earn a higher rate of return (on a risk-adjusted basis). Also the high liquidity of securities means that investors can trade them for cash at their own convenience. * Asset backed securities allows the isolation of credit risk from the originator.

This could benefit investors in that they are not exposed to the banks risks of which could increase the credit rating of the underlying assets themselves. * Investors also get the opportunity to invest in a specific pool of high quality assets: Due to the stringent requirements for corporations (for example) to attain high ratings, there is a dearth of highly rated entities that exist. Securitizations, however, allow for the creation of large quantities of AAA, AA or A rated bonds, and risk averse institutional investors, or investors that are required to invest in only highly rated assets, have access to a larger pool of investment options. Investors can gain portfolio diversification as they tend to invest in securities that may be uncorrelated to their other bonds and securities.

The Financial System

In general securitisation, being part of innovation has benefits for the financial system and the economy as a whole by contribution to the basic functions of the financial system: risk-transference, pricing of risk, liquidity-enhancement, credit-generation and financial intermediation, insurance, asset and liability management, an efficient allocation of financial resources, and the funding of financial institutions.

Securitisation as a technique means that loans are assed more frequently and hence to current terms as when they are just on a bank's balance sheet. In a way this allows the risks prices to be adjusted accordingly. Also another important direct contribution is the ability that it offers banks to lend more to the economy by knowing that it can sell the loans. This has its drawbacks which will be discussed later, but while it is possible, it helps the real

economy as governments encourage more lending for the betterment of the real economy.

In addition, securitisation allows different parties to concentrate on their comparative advantages such as banks being originators. It is in this ways that securitisation increases the efficiency of the financial system which is a social benefit to its people. The Bank for international settlements summarises this in '" the development of credit risk transfer [CRT] has a potentially important impact on the functioning of the financial system. It provides opportunity for more effective risk management, promises the relaxation of some constraints on credit availability, and allows more efficient allocation of risk to a wider range of entities.

The pricing information provided by new CRT markets is also leading to enhanced transparency and liquidity in credit markets. " 3. Disadvantages of secondary securitisation

The Issuer

The first transaction has to be significant and it can be costly also. There are compliance costs and reduced control by the originator of the assets sold to the SPV. * Though it the securitisation structure looks fairly simple, just like other CRS (credit shifting instruments), they are very complex in nature, to the extent that banks and other institutions did not fully understand the risks which they were taking and exposing themselves to.

As seen in the crisis, the risk were not always shifted, sometimes they were just transferred, from credit risk to a liquidity risk and finally to a funding risk , which was evident in the crisis when Interbank Market almost dried up and there was no securities trading. This is what contributed to the financial crisis

as while every bank was diversifying into this business, they financial system became less diverse. If banks do this in large amounts, they could become dependent on the securities market which proved to have it consequences, when trading ceased. As the wealthy reader summarised; “ Without risks, bank went crazy. Credit scores didn't matter, " liar loans" were common”. This proved to back fire for the banks themselves because they were also investing in securities issued by other banks and it led to huge losses for the banks.

The Investors

Securitisation exposes investors to a number of risks such as * Credit/default risk when maintenance obligations on the underlying collateral are not sufficiently met as detailed in its prospectus. A key indicator of a particular security’s default risk is its credit rating. Different tranches within the ABS are rated differently, with senior classes of most issues receiving the highest rating, and subordinated classes receiving correspondingly lower credit ratings’. However, the crisis has exposed a potential flaw in the securitisation process; ‘ loan originators retain no residual risk for the loans they make, but collect substantial fees on loan issuance and securitization, which doesn't encourage improvement of underwriting standards’. Prepayment/reinvestment/early amortisation: The majority of revolving ABS is subject to some degree of early amortization risk. The risk stems from specific early amortization events or payout events that cause the security to be paid off prematurely. Typically, payout events include insufficient payments from the underlying borrowers, insufficient excess Fixed Income Sectors: Asset-Backed Securities spread, a rise in the default rate on the

underlying loans above a specified level, a decrease in credit enhancements below a specific level, and bankruptcy on the part of the sponsor or servicer. Currency interest rate fluctuations: Like all fixed income securities, the prices of fixed rate ABS move in response to changes in interest rates but floating rate securities are affected more. * Moral hazard: Investors usually rely on the deal manager to price the securitizations' underlying assets. If the manager earns fees based on performance, there may be a temptation to mark up the prices of the portfolio assets. ' Conflicts of interest can also arise with senior note holders when the manager has a claim on the deal's excess spread' * There is also a risk that the payments will be late from the servicer.

The Financial System

The consequences of securitisation that were experienced in the crisis were expensive as Sir Howard Davies inferred "[CDOs] are the most toxic element of the financial markets today" . Securitisation and Collateralised Debt Obligations (CDOs) are described as two major instruments at the centre of the financial market turmoil. European banks also took on board significant securitisation programmes. . They contributed highly to the global financial crisis which has had massive costs to the tax payers, governments and central banks.

An important aspect of securitisation is that it has changed the traditional model of banking and hence underlying economics of banking. With securitization banks accept deposits, originate loans, utilizes it comparative advantages, as it did traditionally. However with securitisation is does not accept risk, does not hold it on its balance sheet and therefore needs no capital backing and insurance, things which it traditionally did. This change

of model have had severe implication for the financial system as banks stopped acting like banks, and it was clear that they did not quite understand the implications.

Another big effect is the effect that this had had on the financial system stability of which in itself is an ambiguous issue. 4. Conclusion There has been a division in the overall effects of securitisation to the global economy and financial system. While influential people like Warren Buffet regard it as a lethal weapon, others think the opposite. Regardless of the costs there are substantial benefits for the system. It is now evident that when a securitisation gets beyond the critical device of market participants, however, it is capable of destroying value.

The potential harm is greater in globally interconnected markets. Hence it would be beneficial for the whole system if regulators, supervisors and all participants learn the flaws of securitisation from the crisis and improve the process to form one which ensures that the benefits are derived at the minimum costs, or no costs. As Professor David Llewellyn states; “ the baby (of securitisation) should not be drowned in the bathwater (of regulation)”.

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