BACK TO BASICS

What Is Securitization?

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THE SUBPRIME mortgage crisis that began in 2007 has given the decades-old concept of securitization a bad name. Securitization is the process in which certain types of assets are pooled so that they can be repackaged into interest-bearing securities. The interest and principal payments from the assets are passed through to the purchasers of the securities.

Securitization got its start in the 1970s, when home mortgages were pooled by U.S. government-backed agencies. Starting in the 1980s, other income-producing assets began to be securitized, and in recent years the market has grown dramatically. In some markets, such as those for securities backed by risky subprime mortgages in the United States, the unexpected deterioration in the quality of some of the underlying assets undermined investor confidence. Both the scale and persistence of the attendant credit crisis seem to suggest that securitization—together with poor credit origination, inadequate valuation methods, and insufficient regulatory oversight—could severely hurt financial stability.

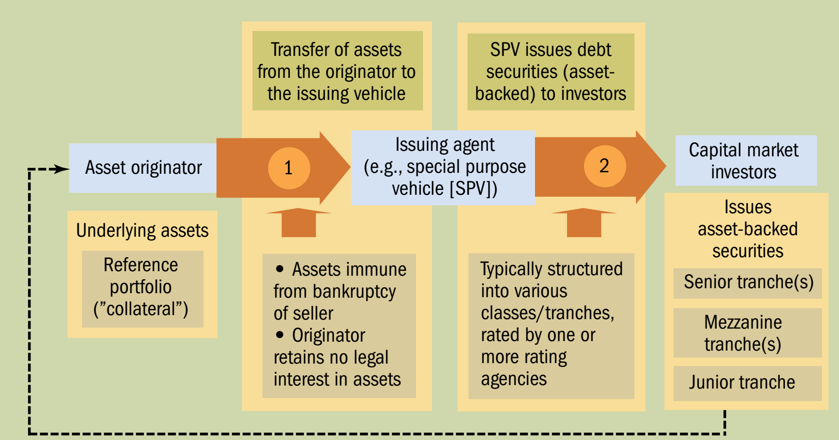
Increasing numbers of financial institutions employ securitization to transfer the credit risk of the assets they originate from their balance sheets to those of other financial institutions, such as banks, insurance companies, and hedge funds. They do it for a variety reasons. It is often cheaper to raise money through securitization, and securitized assets were then less costly for banks to hold because financial regulators had different standards for them than for the assets that underpinned them. In principle, this "originate and distribute" approach brought broad economic benefits too—spreading out credit exposures, thereby diffusing risk concentrations and reducing systemic vulnerabilities.

Until the subprime crisis unfolded, the impact of securitization appeared largely to be positive and benign. But securitization also has been indicted by some for compromising the incentives for originators to ensure minimum standards of prudent lending, risk management, and investment, at a time when low returns on conventional debt products, default rates below the historical experience, and the wide availability of hedging tools were encouraging investors to take more risk to achieve a higher yield. Many of the loans were not kept on the balance sheets of those who securitized them, perhaps encouraging originators to cut back on screening and monitoring borrowers, resulting possibly in a systematic deterioration of lending and collateral standards.

The securitization process

In its most basic form, the process involves two steps (see chart). In step one, a company with loans or other income-producing assets—the originator—identifies the assets it wants to remove from its balance sheet and pools them into what is called the reference portfolio. It then sells this asset pool to an issuer, such as a special purpose vehicle (SPV)—an entity set up, usually by a financial institution, specifically to purchase the assets and realize their off-balance-sheet treatment for legal and accounting purposes. In step two, the issuer finances the acquisition of the pooled assets by issuing tradable, interest-bearing securities that are sold to capital market investors. The investors receive fixed or floating rate payments from a trustee account funded by the cash flows generated by the reference portfolio. In most cases, the originator services the loans in the portfolio, collects payments from the original borrowers, and passes them on—less a servicing fee—directly to the SPV or the trustee. In essence,

How securitization works



securitization represents an alternative and diversified source of finance based on the transfer of credit risk (and possibly also interest rate and currency risk) from issuers to investors.

In a more recent refinement, the reference portfolio is divided into several slices, called tranches, each of which has a different level of risk associated with it and is sold separately. Both investment return (principal and interest repayment) and losses are allocated among the various tranches according to their seniority. The least risky tranche, for example, has first call on the income generated by the underlying assets, while the riskiest has last claim on that income. The conventional securitization structure assumes a three-tier security design—junior, mezzanine, and senior tranches. This structure concentrates expected portfolio losses in the junior, or first loss position, which is usually the smallest of the tranches but the one that bears most of the credit exposure and receives the highest return. There is little expectation of portfolio losses in senior tranches, which, because investors often finance their purchase by borrowing, are very sensitive to changes in underlying asset quality. It was this sensitivity that was the initial source of the problems in the subprime mortgage market last year. When repayment issues surfaced in the riskiest tranches, lack of confidence spread to holders of more senior tranches—causing panic among investors and a flight into safer assets, resulting in a fire sale of securitized debt.

Securitization was initially used to finance simple, self-liquidating assets such as mortgages. But any type of asset with a stable cash flow can in principle be structured into a reference portfolio that supports securitized debt. Securities can be backed not only by mortgages but by corporate and sovereign loans, consumer credit, project finance, lease/trade receivables, and individualized lending agreements. The generic name for such instruments is asset-backed securities (ABS), although securitization transactions backed by mortgage loans (residential or commercial) are called mortgage-backed securities. A variant is the collateralized debt obligation, which uses the same structuring technology as an ABS but includes a wider and more diverse range of assets.

The allure of securitizing

Securitization started as a way for financial institutions and corporations to find new sources of funding—either by moving assets off their balance sheets or by borrowing against them to refinance their origination at a fair market rate. It reduced their borrowing costs and, in the case of banks, lowered regulatory minimum capital requirements.

For example, suppose a leasing company needed to raise cash. Under standard procedures, the company would take out a loan or sell bonds. Its ability to do so, and the cost, would depend on its overall financial health and credit rating. If it could find buyers, it could sell some of the leases directly, effectively converting a future income stream to cash. The problem is that there is virtually no secondary market for individual leases. But by pooling those leases, the company can raise cash by selling the package to an issuer, which in turn converts the pool of leases into a tradable security.

Moreover, the assets are detached from the originator's balance sheet (and its credit rating), allowing issuers to raise funds to finance the purchase of assets more cheaply than would be possible on the strength of the originator's balance sheet alone. For instance, a company with an overall "B" rating with "AAA"-rated assets on its books might be able to raise funds at an "AAA" rather than "B" rating by securitizing those assets. Unlike conventional debt, securitization does not inflate a company's liabilities. Instead it produces funds for future investment without balance sheet growth.

Investors benefit from more than just a greater range of investible assets made available through securitization. The flexibility of securitization transactions also helps issuers tailor the risk-return properties of tranches to the risk tolerance of investors. For instance, pension funds and other collective investment schemes require a diverse range of highly rated long-term fixed-income investments beyond what the public debt issuance by governments can provide. If securitized debt is traded, investors can quickly adjust their individual exposure to credit-sensitive assets in response to changes in personal risk sensitivity, market sentiment, and consumption preferences at low transaction cost.

Sometimes the originators do not sell the securities outright to the issuer (called "true sale securitization") but instead sell only the credit risk associated with the assets without the transfer of legal title ("synthetic securitization"). Synthetic securitization helps issuers exploit price differences between the acquired (and often illiquid) assets and the price investors are willing to pay for them (if diversified in a greater pool of assets).

Growth of securitization

The landscape of securitization has changed dramatically in the last decade. No longer is it wed to traditional assets with specific terms such as mortgages, bank loans, or consumer loans (called self-liquidating assets). Improved modeling and risk quantification as well as greater data availability have encouraged issuers to consider a wider variety of asset types, including home equity loans, lease receivables, and small business loans, to name a few. Although most issuance is concentrated in mature markets, securitization has also registered significant growth in emerging markets, where large and highly rated corporate entities and banks have used securitization to turn future cash flow from hard-currency export receivables or remittances into current cash.

In the future, securitized products are likely to become simpler. After years of posting virtually no capital reserves against highly rated securitized debt, issuers will soon be faced with regulatory changes that will require higher capital charges and more comprehensive valuation. Reviving securitization transactions and restoring investor confidence might also require issuers to retain interest in the performance of securitized assets at each level of seniority, not just the junior tranche. ■

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