Securitization

••Securitization will be reborn as a result of the recent meltdown of credit and investment markets. This rebirth will focus on transparency, hidden risks, and modeling accuracy related to the obligations being securitized. This is part one of a two-part series.

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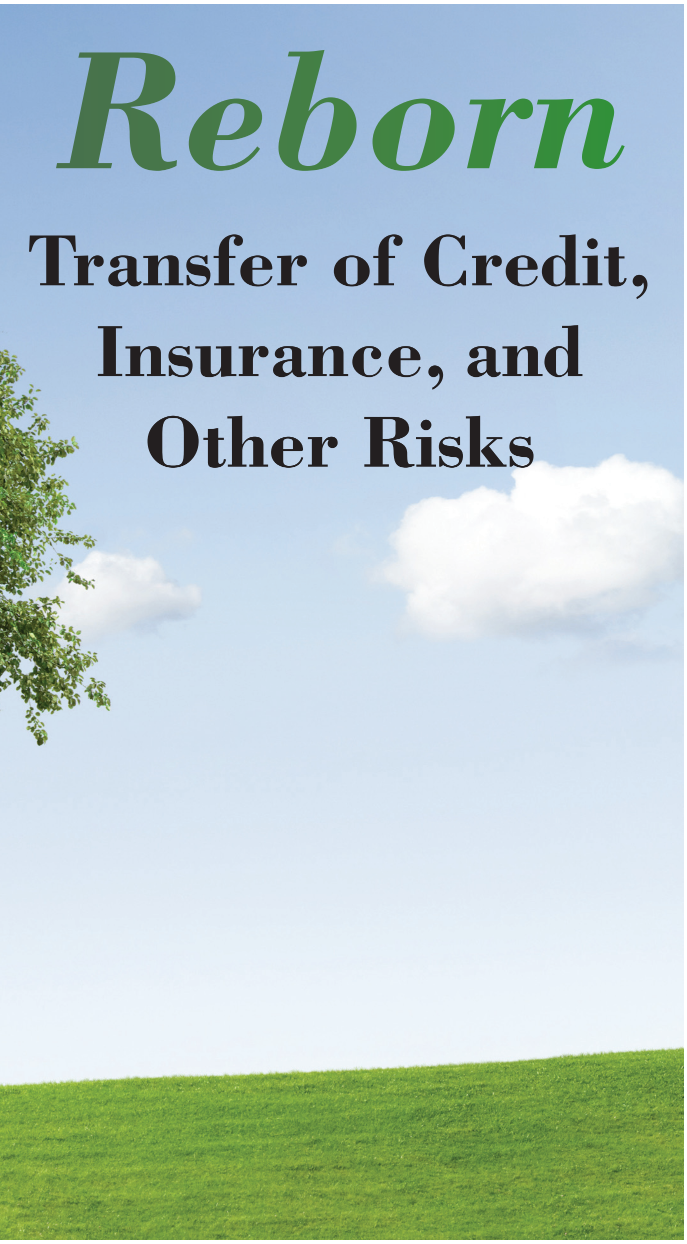

Reborn

Transfer of Credit, Insurance, and Other Risks

BY DAVID KOEGEL

THE VOLATILE ECONOMIC environment has largely shut down the securitization market in the past 18 months. Nevertheless, in the near future, that same environment will present the opportunity for a rebirth of the securitization process—a rebirth that can provide the market with greater levels of transparency, oversight, and reliability of data. Although the recent credit crisis did not arise from the practice of securitization, its misuse in certain cases and the inferior quality of available information were contributing factors. Drawbacks in the securitization process have included insufficient distinctions among accounting treatments for assets having different levels of credit risk, as well as overreliance on rating agencies' valuations.

Securitizations comprise a wide group of financial instruments that are used to transfer risks to third parties. Financial instruments that strip out and isolate the credit risk of underlying assets and transfer it to other parties can be broadly referred to as *credit-linked securities* (CLS). In a similar fashion, risk to insurers of policyholders making claims for indemnification of insured losses may be transferred in a form broadly referred to as *insurance-linked securities* (ILS). While conceptually similar to insurance, CLS and ILS are hedging mechanisms and not actual insurance products. This first article in the series will discuss the advantages and disadvantages shared by nearly all securitizations and the efforts already under way to rejuvenate the market for the securitization of CLS. A second article will describe the development of ILS and their expanding role in risk management and investment programs.

What Is Securitization and Why Use It?

The term *securitization* broadly refers to a financing and risk-transfer technique in which a collection of monetary obligations is transformed into an investment security. The essential function of securitization is to enable an exchange of certain assets for immediate cash that otherwise might not be possible. Securitization is facilitated by reliance on strong historical operating cash flows to support repayment of debt or payment of other financial commitments. Obligations backing the securitization can include mortgage loans, credit card receivables, and leases. For example, mortgage-backed securities (MBS) are securitizations that result in the creation of bonds whose cash flows are linked to and derived from principal and interest payments related to pools of mortgages.

There are several benefits to the originator of obligations subject to the securitization:

- Lower cost of financing.
- Increased liquidity and credit capacity.
- Diversified risk exposure.
- Removal of assets from the balance sheet.

Potential for significant expense savings, easier access to credit, and better spread of risk are three popular attributes of securitization. These benefits, combined with improved financial ratios as a result of moving assets off balance sheet, can all be realized if the transaction is structured properly. The created securities can be sold more easily in the capital markets if they can be rated independent of the originator's financial condition and the actual rating determined largely on the strength of the underlying collateral and factors that may serve to reduce the likelihood of default. As an example, senior auto-loan-backed securities issued by Ford Motor Credit maintained their AAA rating in 2002 even after the company's rating was downgraded. It was the strength of the underlying collateral and other credit enhancements at the time that protected the sacred AAA rating on the securities.

Concerns with Securitization and Risks to Investors

Benefits of securitization may be partially offset by the following concerns:

- Reduction of investors' ability to distinguish between similar-looking AAA securities.
- Introduction of complexity that requires significant energy and resources to analyze.
- Segmentation of the risk-taking process, resulting in a relaxation of internal controls.
- Amplification of general indebtedness due to cheap credit.

Taken together, those various concerns define securitization's primary risks to investors: lack of transparency, which makes understanding and analyzing the security much more difficult, and contingent events that can cause the security to be paid off prematurely (such as when underlying borrowers pay off mortgages early to refinance at a lower cost). Prepayment risk associated with securitizations generally exposes bondholders to reduced cash flows. While default risk is more a function of credit risk, prepayment risk is more a function of market risk (interest rates, market competition, etc.), which makes valuing the security even more troublesome.

More recently, a broad uneasiness about securitizations has developed from the unfortunately frequent association of securitized pools of indebtedness with subprime mortgages and other problematic debt. By being able to move subprime loans into the capital markets via credit enhancement, securitization critics view lenders as having relinquished at least a portion of their responsibility to thoroughly evaluate borrowers' creditworthiness. For all too many debt-market participants, the process of securitization, which can include almost any kind of debt, has become synonymous with the securitization of poor-quality debt (for example, subprime adjustable-rate, no-down-payment, undocumented mortgages). Such inferior debt is characterized by underestimated default rates, the true value of which became clear only with the passage of time and unhappy experience.

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Financial Crisis Precipitates Rebirth of Securitization

Securitization will be reborn as a result of the recent meltdown of credit and investment markets. This rebirth will focus on transparency, hidden risks, and modeling accuracy related to the obligations being securitized. In the meantime, the government has recently stepped in: The Treasury Department and the Federal Reserve have jointly launched the Term Asset-Backed Securities Loan Facility (TALF). In its first phase, TALF will lend up to $200 billion on a collateralized, nonrecourse basis for a three-year term to holders of eligible asset-backed securities. Securities eligible for the TALF include newly issued AAA-rated tranches of securitizations backed by auto loans, credit card loans, private and government-guaranteed student loans, and loans guaranteed by the Small Business Administration.

The TALF has been structured to minimize credit risk for the U.S. government by imposing the following requirements:

1. Eligible securities must satisfy several credit rating criteria.
2. Issuers must hire an external auditor to validate the eligibility of the securities.
3. Private investors unrelated to the issuer must provide collateral to the Federal Reserve in an amount greater than the loan. (The relative percentage differences between loan amounts and required collateral are referred to as "haircuts" and vary based on assessment of the riskiness of the securities.)
4. Interest rate spreads or risk premiums in the TALF loan rates as a first loss position to hold the security are surrendered to the facility in lieu of repayment.

According to Tim Zawacki, senior editor at SNL Financial, "TALF haircuts for certain asset classes have resulted in a more expensive way of funding for issuers that could be an impediment to the recovery of the securitization market."

Of note in the attempt to reincarnate the securitization process are recent efforts by the American Securitization Forum (ASF), a broad-based professional medium through which participants in the U.S. securitization market advocate their common interest on significant legal, regulatory, and market practice issues.

In July 2008, the ASF publicly launched its Project on Residential Securitization Transparency and Reporting (Project RESTART). It is designed to restore investor confidence in mortgage and asset-backed securities by implementing new procedures for disclosure and reporting by issuers and servicers of both new and outstanding transactions. Project RESTART has been acknowledged as essential to the enhancement of the securitization process. By advocating more comprehensive standards for transparency, disclosure, and diligence, Project RESTART should improve market discipline and the ability of investors to differentiate pools of varying credit quality. This improved ability to differentiate levels of credit risk may also make it easier to better align financial incentives of the originators and purchasers of the loans. It is further thought that Project RESTART will facilitate more thorough and reliable valuations of asset-backed transactions that are necessary to create critical liquidity from the secondary market.

The recent credit crisis highlights the need to enact basic modifications to the securitization process—for example, make underlying risk more transparent to investors and credit rating agencies, improve the quality of due diligence on the underlying assets being securitized, and strengthen governance processes for eliminating assets that should not be securitized. Investor and rating-agency models are being adjusted and data inputs are being improved, which should enable a supply of capital and liquidity to return to the securitization market at a reduced cost. "Failure in due diligence has been characterized by a buy-first, ask-later mentality," Zawacki said. "So long as the blame game persists in the industry, one can only wonder when the recovery of the securitization market will begin."

As part of Project RESTART, the ASF has proposed a disclosure package for use at the initiation of residential MBS, consisting of 135 data fields of pool and specific credit information. The disclosure package and related deliverables are intended to:

1. Increase the amount of clearly defined and accessible data on underlying credit risks, which is critical to investors, rating agencies, and other eligible market participants.
2. Standardize the presentation of transaction and credit-specific data, enabling investors to perform better comparative analyses of loans and transactions across all issuers.
3. Explain how the data is to be obtained, permitting investors to conduct detailed evaluations of transactions to better estimate the likelihood that underlying obligations will be paid.

The ASF has also proposed a package of data fields to be updated monthly by servicers throughout the life of all outstanding and newly issued transactions. Monthly updating of critical credit-specific information should improve the ability of investors to monitor and reevaluate the securities on an ongoing basis. The intent is to help increase both short- and longer-term trading activity by providing investors with the up-to-date, reliable, and relevant information required by secondary-market participants to evaluate distressed assets. For similar reasons, the ASF intends to develop a comparable reporting package for credit card asset-backed securities.

The ASF is targeting an implementation date of December 1, 2009, for all deliverables associated with Project RESTART and is seeking comments from industry participants in the interim.[1]

Securitization Reborn

Growth in risk-transfer markets has highlighted the interdependency between banks and insurance companies, connecting these two financial sectors and markets more closely. Banks have been transferring credit risks to insurance companies, among others, and insurance companies have been issuing "catastrophe bonds" that are being sold to institutional investors. Although interest in cross-sectoral risk transfer is not a new trend, it has recently become even more critical for investors and policy makers to recognize distinctions between the securitization of assets (mortgages, credit card receivables, car loans, etc.) and the securitization of liabilities.

Liability securitization can be an equally useful capital management tool for both buyers and sellers of insurance risk protection.

Most life insurance securitizations are similar to the asset-backed securities currently offered by banks and are prone to many of the same issues associated with those instruments. Some life insurance securitizations, for example, are backed by the embedded value of future profits from a pool of life insurance policies. On the other hand, for property and casualty (P&C) securitizations, it's important to recognize the distinction between the transfer of assets and the transfer of liabilities.

Risks in bank assets tend to be correlated, as further evidenced by the recent subprime crisis. This correlation provides a strong risk-transfer incentive for bankers to diversify their asset portfolios. In contrast, most P&C liabilities are often uncorrelated or only weakly correlated. Hurricanes, for example, severely impact a relatively small geographic area and have limited parallel effects on a national or global basis. While the diversification characteristic of a typical P&C portfolio reduces the incentive for P&C insurers to transfer their insurance risks to the capital markets, lack of correlation to existing asset portfolios is exactly what makes insurance-linked securities potentially desirable to investors. Meanwhile, P&C insurers have another incentive to transfer risk: It's a way to obtain additional capacity (mainly for catastrophic risk). Therefore, liability securitization can be an equally useful capital management tool for both buyers and sellers of insurance risk protection.

Part two of this article, appearing next month, will continue to discuss the rebirth of securitization and offer further comparisons between credit and insurance risk transfers, including implications of the credit crisis for the insurance-linked securities market. ❖

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1. Further information about Project RESTART can be found on the ASF Web site, www.americansecuritization.com/story.aspx?id=2656.