The Process of Securitisation

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Securitisation is a well-established practice in the global debt capital markets. It was introduced initially as a means of funding for US mortgage banks. Subsequently, the technique was applied to other assets such as credit card payments and leasing receivables. It has also been employed as part of asset/liability management, as a means of managing balance sheet risk.

In this article we introduce the basic concepts of securitisation, before illustrating the process with an hypothetical case study.

Introduction

Sundaresan (1997) defines securitisation as,

> "…simply stated.....a framework in which some illiquid assets of a corporation or a financial institution are transformed into a package of securities backed by these assets, through careful packaging, credit enhancements, liquidity enhancements and structuring."
> (page 359)

The process of securitisation creates a*sset-backed bonds.* These are debt instruments that have been created from a package of loan assets on which interest is payable, usually on a floating basis. The asset-backed market was developed in the United States and is a large, diverse market containing a wide range of instruments. Techniques employed by investment banks today enable an entity to create a bond structure from any type of cash flow; assets that have been securitised include loans such as residential mortgages, car loans, and credit card loans. The loans form assets on a bank or finance house balance sheet, which are packaged together and used as backing for an issue of bonds. The interest payments on the original loans form the cash flows used to service the new bond issue. Traditionally mortgage-backed bonds are grouped in their own right as mortgage-backed securities (MBS) while all other securitisation issues are known as asset-backed bonds or ABS.

B. Basic concepts

Reasons for undertaking securitisation

The driving force behind securitisation has been the need for banks to realise value from the assets on their balance sheet. Typically these assets are residential mortgages, corporate loans, and retail loans such as credit card debt. Let us consider the factors that might lead a financial institution to securitise a part of its balance sheet.

A bank may wish to reduce the size of its balance sheet for the following reasons:

- if revenues received from assets remain roughly unchanged but the size of assets has decreased, this will lead to an increase in the return on equity ratio;

- the level of capital required to support the balance sheet will be reduced, which again can lead to cost savings or allows the institution to allocate the capital to other perhaps more profitable, business;

- to obtain cheaper funding: frequently the interest payable on ABS securities is considerably below the level payable on the underlying loans. This creates a cash surplus for the originating entity.

By entering into securitisation a lower-rated entity can access debt capital markets that would otherwise be the preserve of higher-rated institutions.

The securitisation process involves a number of participants. In the first instance is the *originator*, the firm whose assets are being securitised. The most common process involves an *issuer* acquiring the assets from the originator. The issuer is usually a company that has been specially set up for the purpose of the securitisation and is known as a *special purpose vehicle* or SPV and is usually domiciled offshore. The creation of an SPV ensures that the underlying asset pool is held separate from the other assets of the originator. This is done so that in the event that the originator is declared bankrupt or insolvent, the assets that have been transferred to the SPV will not be affected..

By holding the assets within an SPV framework, defined in formal legal terms, the financial status and credit rating of the originator becomes almost irrelevant to the bondholders. The process of securitisation often involves credit enhancements, in which a third-party guarantee of credit quality is obtained, so that notes issued under the securitisation are often rated at investment grade and up to AAA-grade.

The process of structuring a securitisation deal ensures that the liability side of the SPV – the issued notes – carries lower cost than the asset side of the SPV. This enables the originator to secure lower cost funding that it would otherwise be able to obtain in the unsecured market. This is a tremendous benefit for institutions with lower credit ratings

Figure 1 illustrates in simple fashion the process of securitisation.

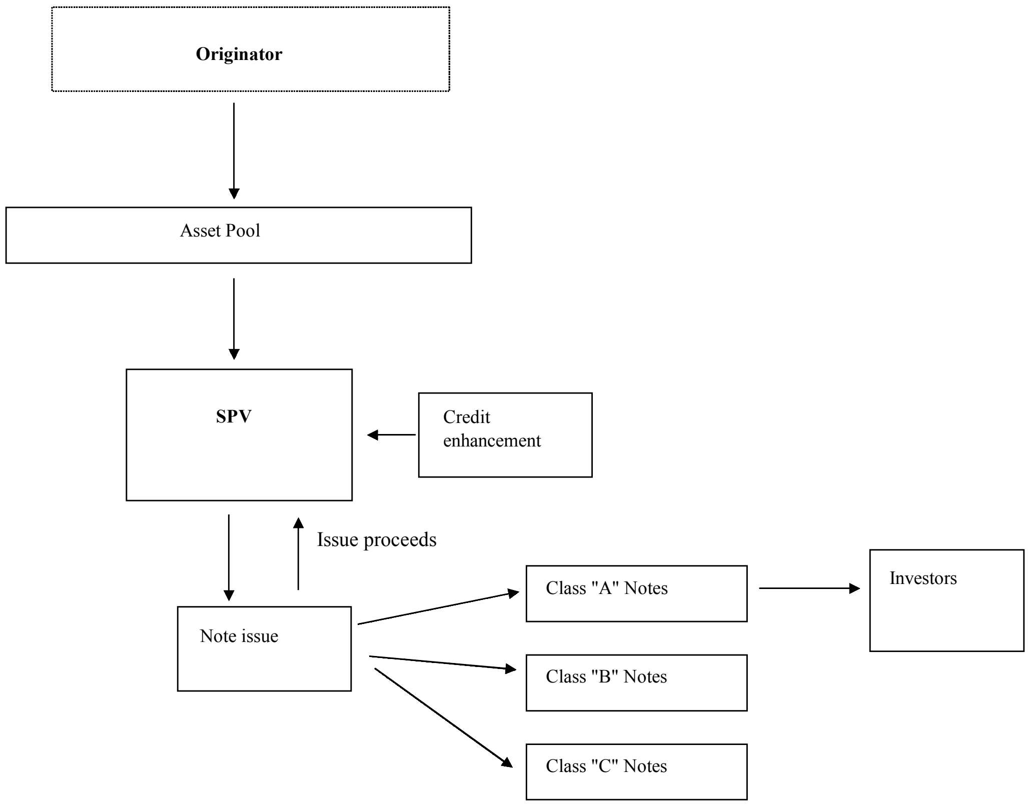

Figure 1 Securitisation process

Mechanics of securitisation
Securitisation involves a "true sale" of the underlying assets from the balance sheet of the originator. This is why a separate legal entity, the SPV, is created to act as the issuer of the notes. The assets being securitised are sold onto the balance sheet of the SPV. The process involves:

- undertaking "due diligence" on the quality and future prospects of the assets;
- setting up the SPV and then effecting the transfer of assets to it;
- underwriting of loans for credit quality and servicing;
- determining the structure of the notes, including how many tranches are to be issued, in accordance to originator and investor requirements;
- the notes being rated by one or more credit rating agencies;
- placing of notes in the capital markets.

The sale of assets to the SPV needs to be undertaken so that it is recognised as a true legal transfer. The originator will need to hire legal counsel to advise it in such matters. The credit rating process will consider the character and quality of the assets, and also whether any enhancements have been made to the assets that will raise their credit quality. This can include *overcollateralisation,* which is when the principal value of notes issued is lower than the principal value of assets, and a liquidity facility provided by a bank.

A key consideration for the originator is the choice of the underwriting bank, which structures the deal and places the notes. The originator will award the mandate for its deal to the bank on the basis of fee levels, marketing ability and track record with its type of assets.

Illustrating the process of securitisation

To illustrate the process of securitisation, we consider an hypothetical airline ticket receivables transaction. The purpose of this section is to show the issues that will be considered by the investment bank that is structuring the deal.

Originator ABC Airways plc

Transaction Ticket receivables airline future flow securitisation bonds
€200m three-tranche floating rate notes, legal maturity 2012, average life 4.1 years

Issuer "Airways No 1 Ltd"

Arranger XYZ Securities plc

Due diligence
XYZ Securities will undertake due diligence on the assets to be securitised. For this case, it will examine the airline performance figures over the last five years, as well as model future projected figures, including:

- total passenger sales
- total ticket sales
- total credit card receivables
- geographical split of ticket sales

It is the future flow of receivables, in this case credit card purchases of airline tickets, that is being securitised. This is a higher-risk asset class than say, residential mortgages, because the airline industry has a tradition of greater volatility of earnings than say, mortgage banks.

Marketing approach
The present and all future credit card ticket receivables generated by the airline will be transferred to an SPV. The investment bank's syndication desk will seek to place the notes with institutional investors across Europe. The notes are first given an indicative pricing ahead of the issue, to gauge investor sentiment. Given the nature of the asset class, during

November 2002 the notes would be marketed at around three-month Libor plus 70-80 basis points (AA note), 120-130 basis points (A note) and 260-270 basis points (BBB note). The notes are "benchmarked" against recent issues with similar asset classes, as well as the spread level in the unsecured market of comparable issuer names.

Deal structure
The deal structure is shown at figure 2.

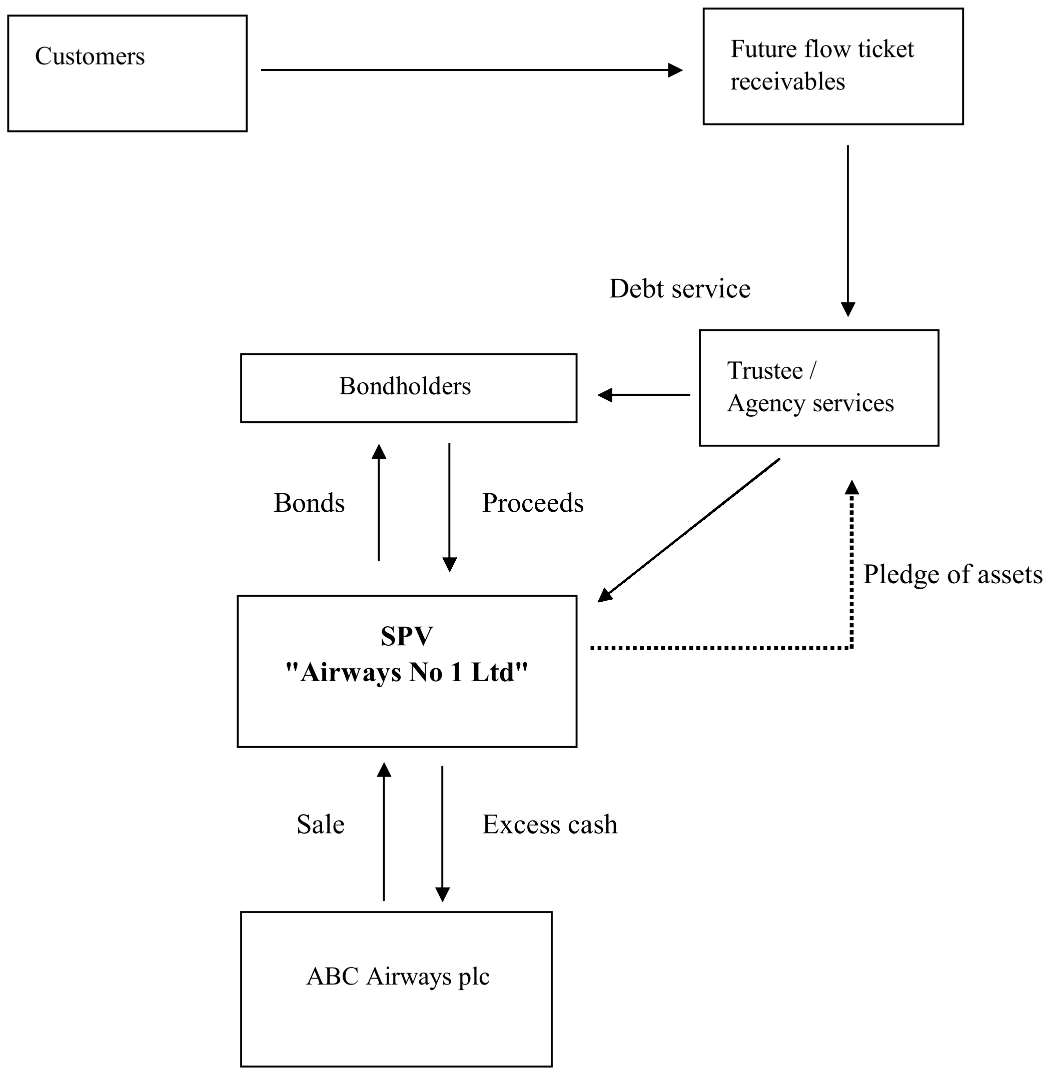

Figure 2 Airways No1 Limited deal structure

The process leading to issue of notes is as follows:

- ABS Airways plc sells its future flow ticket receivables to an offshore SPV set up For this deal, incorporated as Airways No 1 Ltd;
- the SPV issues notes in order to fund its purchase of the receivables;

- the SPV pledges its right to the receivables to a fiduciary agent, the Security Trustee, fore the benefit of the bondholders;

- the Trustee accumulates funds as they are received by the SPV;

- the bondholders receive interest and principal payments, in the order of priority of the notes, on a quarterly basis.

In the event of default, the Trustee will act on behalf of the bondholders to safeguard their interests.

Financial guarantors
The investment bank will consider if an insurance company, known as a monoline insurer, should be approached to "wrap" the deal by providing a guarantee of backing for the SPV in the event of default. This insurance is provided in return for a fee.

Financial modelling
XYZ Securities will construct a cashflow model to estimate the size of the issued notes. The model will consider historical sales values, any seasonal factors in sales, credit card cash flows, and so on. Certain assumptions will be made when constructing the model, for example growth projections, inflation levels, tax levels, and so on. The model will consider a number of different scenarios, and also calculate the minimum asset coverage levels required to service the issued debt. A key indicator in the model will be the debt service coverage ratio (DSCR). The more conservative the DSCR, the more comfort there will be for investors in the notes. For a residential mortgage deal, this ratio might be approximately 2.5 – 3.0; however for an airline ticket receivables deal, the DSCR would be unlikely to be lower than 4.0. The model will therefore calculate the amount of notes that can be issued against the assets, whilst maintaining the minimum DSCR.

Credit rating
It is common for securitisation deals to be rated by one or more of the formal credit ratings agencies such as Moody's, Fitch or Standard & Poor's. A formal credit rating will make it easier for XYZ Securities to place the notes with investors. The methodology employed by the ratings agencies takes into account both qualitative and quantitative factors, and will differ according to the asset class being securitised. The main issues in a deal such as our hypothetical Airway No 1 deal would be expected to include:

- corporate credit quality: these are risks associated with the originator, and are factors that affect its ability to continue operations, meet its financial obligations, and provide a stable foundation for generating future receivables. This might be analysed according to the following: (i) ABC Airways' historical financial performance, including its liquidity and debt structure; (ii) its status within its domicile country, for example whether it is state-owned; (iii) the general economic conditions for industry and for airlines and (iv) the historical record and current state of the airline, for instance its safety record and age of its aeroplanes;

- the competition and industry trends: ABC Airways' market share, the competition on its network;

- regulatory issues, such as need to comply with forthcoming legislation that would impact its cash flow;

- legal structure of the SPV and transfer of assets;

- cash flow analysis.

Based on the findings of the ratings agency, the arranger may re-design some aspect of the deal structure so that the issued notes are rated at the required level.

This is a selection of the key issues involved in the process of securitisation. Depending on investor sentiment, market conditions and legal issues, the process from inception to closure of the deal may take anything from three to 12 months or more. After the notes have been issued, the arranging bank will no longer have anything to do with the issue; however the bonds themselves require a number of agency services for their remaining life until they mature or are paid off. These agency services can include paying agent, cash manager and custodian.

SAMPLE TRANSACTIONS

Case study 1
Shipshape Residential Mortgages No 1

Bristol & West plc is a former UK building society that is now part of the Bank of Ireland group. In October 2000 it issued £300 million of residential mortgage-backed securities through ING Barings. It was the third time that Bristol & West had undertaken a securitisation of part of its mortgage book. The Shipshape Residential Mortgages No 1 was structured in the following way:

- a £285 million tranche senior note, rated Aaa by Moody’s and Fitch IBCA, with an average life of 3.8 years and paying 25 basis points over three-month Libor;

- a class “B” note of £9 million, rated A1 by Moody’s and paying a coupon on 80 basis points over three-month Libor. These notes had an average life of 6.1 years;

- a junior note of £6 million nominal, rated triple-B by Moody’s and with an average life of 6.8 years. These notes paid a coupon of 140 basis points over Libor.

Case study 2
Fosse Securities No 1 plc

This was the first securitisation undertaken by Alliance & Leicester plc, another former UK building society which converted into a commercial bank in 1997. The underlying portfolio was approximately 6,700 loans secured by first mortgages on property in the UK. The transaction was a £250 million securitisation via the SPV, named Fosse Securities No 1 plc.

The underwriter was Morgan Stanley Dean Witter, which placed the notes in November 2000. The transaction structure was:

- a senior class "A" note with AAA/Aaa rating by Standard & Poor's and Moody's, which represented £235 million of the issue, with a legal maturity of November 2032;
- a class "B" note rated Aa/Aa3 of nominal £5 million;
- a class "C" note rated BBB/Baa2 of nominal £10 million.

The ratings agencies cited the strengths of the issue as:[1] the loans were *prime* quality; there was a high level of *seasoning* in the underlying asset pool, with average age of 35 months; the average level of the loan-to-value ratio (LTV) was considered low, at 73.5%; and there were low average loan-to-income multiples amongst underlying borrowers.

Case study 3
SRM Investment No 1 Limited

Sveriges Bostadsfinansieringsaktiebolag (SBAB) is the Swedish state-owned national housing finance corporation. Its second ever securitisation issue was the EUR 1 billion SRM Investment No 1 Limited, issued in October 2000. The underlying asset backing was Swedish residential mortgage loans, with properties being mainly detached and semi-detached single-family properties. The issue was structured and underwritten by Nomura International.

The underlying motives behind the deal were that it allowed SBAB to:

- reduce capital allocation, thereby releasing capital for further lending;
- remove part of its mortgage loan-book off the balance sheet;
- obtain a more diversified source for its funding.

The transaction was structured into the following notes:

- senior class "A1" floating-rate note rated AAA/Aaa by S&P and Moody's, issue size EUR755 million, with a legal maturity date in 2057;
- senior class "A2" fixed coupon note, rated AAA/Aaa and denominated in Japanese yen, incorporating a step-up facility, legal maturity 2057; issue size JPY 20 billion;
- class "M" floating-rate note rated A/A2, due 2057; issue size EUR 20 million;
- class "B" floating-rate note, rated BBB/Baa2, issue size EUR 10 million.

[1] Source: ISR, November 2000

The yen tranche reflects the targeting of a Japanese domestic investor base. On issue the class A1 notes paid 26 basis points over euribor. The structure is illustrated in figure 3.

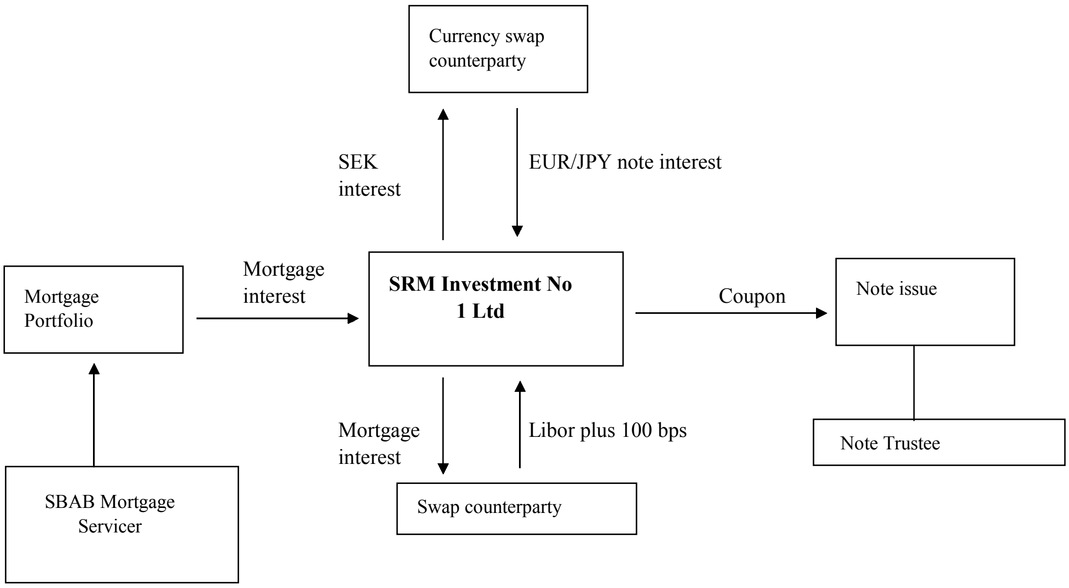

Figure 3 SRM Investment No 1 Limited

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