SECURITISATION – FRIEND NOT FOE

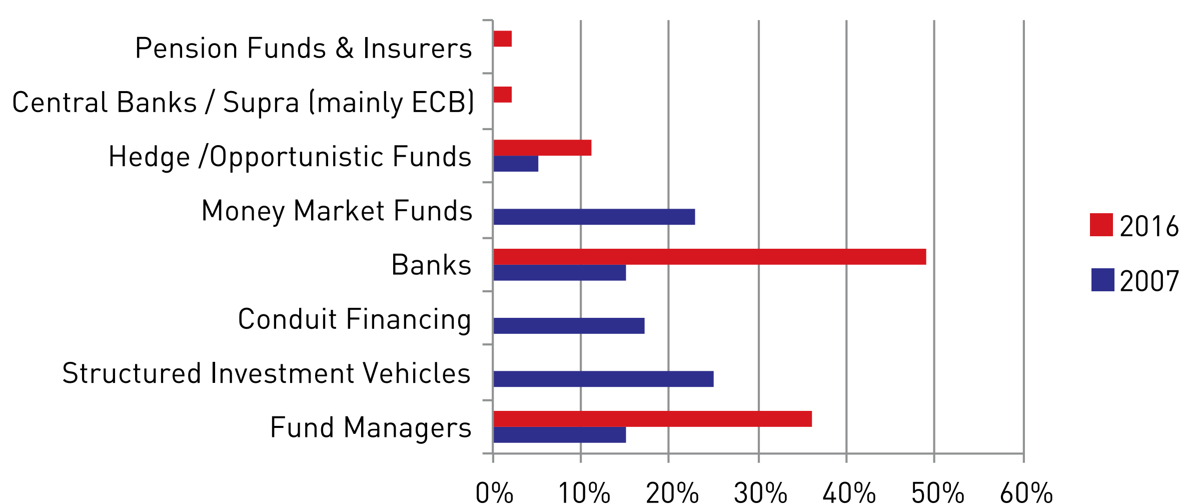
AXA Investment Managers explores how securitisation has evolved since the financial crisis, and dispels the negative myths which have lingered for institutional investors

Securitisation can offer a wealth of benefits to the economy and investors alike. However, the spectre of the US sub-prime home mortgage market means that many investors still associate the idea of securitisation exclusively with the world of sub-prime residential mortgage-backed securities, collateralised debt obligations (CDOs) or leveraged investment vehicles. Rather, since the global financial crisis, the IMF and OECD have encouraged regulators to enable a sustainable recovery of the securitisation markets.

Securitisation is a process by which illiquid financial assets that would otherwise only exist on bank balance sheets are transformed into tradable commodities. In this way, securitisation enables institutional investors to diversify into otherwise granular, inaccessible and illiquid instruments. An example might be a car manufacturer using the process of securitisation to sell their claim on a stream of loan payments (i.e. convert the stream into one lump sum) to finance research and development to remain competitive.

As such, securitisation offers a diverse universe of investments, and market reform over the years has steadily introduced more transparency, investor protection, and better alignment of incentives to the asset class.

Structured finance investor base 2007 vs 2016



Source: RBS Securitised Products Strategy, ConceptABS. Data latest available as at 31 August 2018.

Market reform since 2008

It is interesting to see that despite the troubles of the financial crisis, regulators did not determine that securitisation as a concept needed to be eradicated. Instead, regulation has been a key driver in incentivising various market participants to use securitisation as a structural tool. The positive impacts of these reforms for the investor include:

- **Stronger due diligence:** greater regulatory focus in both the EU and US on the risks of securitised assets has brought about better modelling and understanding of every transaction, and therefore more reliable loan-by-loan risk assessment by investors and tighter underwriting standards by originators. Prior to 2008 there was no obligation for originators or lenders to provide data on the credit quality and performance of the underlying exposures supporting a securitised transaction.
- **Improved credit rating system:** enhanced regulation of rating agencies and users of ratings has developed a more reliable credit rating system. Market reform has helped contain conflicts of interest for ratings agency which had been problematic in the years preceding the financial crisis.
- **Skin in the game:** originators, sponsors or the original lender have to retain a material net economic interest of at least 5% on an ongoing basis of securitised exposure which has led to a better alignment of interest between originators and investors, incentivising originators to assess credit quality diligently. This is better known as having 'skin in the game'. Before 2008, market makers were well within their legal right to distribute all originated loans without the obligation to retain any on their own books, which meant little attention was given to credit quality[1].

An expanding investor base

As a result of the regulatory changes and tighter underwriting criteria, the overall quality of securitised assets is higher which is why securitised assets are now used by banks as funding and capital relief/allocation tools. Securitisation is no longer about banks removing poor quality assets from their balance sheets and passing them on to investors.

Securitised assets have also been put on par with other asset classes in the sense that no specific group of market participants (such as investment banks previously) should benefit from a structural market advantage.

The investor base for structured products has also started to broaden. Central banks, treasury departments of corporates and banks, and traditional fixed income funds have increased their allocation to structured products. Pension funds and insurance companies are beginning to explore these asset classes cautiously.

Outside US sub-prime mortgages, CDOs and leveraged vehicles such as structured investment vehicles (SIVs), securitised assets have caused limited actual credit losses in respect of their level of seniority.

The importance of good deal structures and the risks of securitised assets

There are several significant benefits of securitisation. Firstly, the use of a Special Purpose Vehicle (SPV) isolates pools of loans from the general credit risk of the originator and sepa-

BENEFITS OF SECURITISATION TO LONG-TERM INVESTORS

- Higher risk-adjusted yield
- An alternative way of diversifying away from traditional growth portfolio asset classes
- Diversification within a fixed income portfolio to access other types of credit instruments
- Mitigate against a rising rate environment
- An additional tool to help meet cash flows
- Lower mark-to-market volatility allowing long-term strategic allocations

rates the risk of bankruptcy. Secondly, unlike pass through certificates which simply pass the cash flows on to investors without any reconfiguration, the use of a tranched structure ensures credit risk is distributed commensurate to return level across the various layers, providing credit protection to senior debt holders. Thirdly, credit support gives protection against late payments and acts as a loss absorbing cushion. Finally, a good deal structure could provide benefits in certain market conditions. For example, in a rising credit spread environment, a collateralised loan obligation (CLO) manager would have the opportunity to replace maturing loans by higher yielding ones and purchase loans at discount.

The risks associated with securitised assets depend on the combination of the quality of the underlying collateral pool, the features of the deal structuring and the counterparties involved. Generally, some of the main risks of securitised assets include valuation risk, liquidity risk, concentration risk and credit risk.

Embracing securitisation in an institutional allocation

The size and diversity of the securitised market offers the potential to cover various investors' needs in terms of underlying credit risk, associated risk premium, liquidity, maturity and cash flow. Securitised assets can enable investors to diversify into deeper corporate and consumer credit with lower duration risk and have the potential to offer higher yields than traditional credit at similar rating levels. As market reform has introduced more transparency, investor protection, and better alignment of incentives to the asset class, investors willing to tackle the concept of securitisation could take advantage of the benefits of this market.

FOOTNOTES:

[1] Until very recently, originators, sponsors or original lender have had to retain a material net economic interest (with no sharing of retention) of at least 5% (on an ongoing basis) of securitised exposure. More recently there has been a rollback of this rule in the US CLO market. We continue to see US CLO managers retaining a 5% interest to ensure they are able to cater to the EU risk retention requirements and regulations.

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