

Securitization: global financial market development for the 21st Century

It is a pleasure to be asked to write the Introduction to the Euromoney 2004 Guide to Securitization. These are exciting times for everyone involved in the market worldwide. A sure sign of the success and importance of the tools and techniques used in securitization is their application in diverse markets around the world. A fraction of this diversity is represented in the following pages of this Guide.

That securitization is applied in many different capital markets, and across a multitude of asset classes, reflects its great flexibility but also more importantly its efficiency as a tool for disintermediation. The variety of structures seen in this guide emphasise this vital contribution made by securitization to capital markets' development: as a tool to intermediate between the users of capital and the suppliers of capital. In this respect it has quickly become an essential technique used worldwide. The ability to customise structures, to meet the differing demands of investors as well as originators, has been behind the growth in use of structured finance products. The use of credit derivatives, an important and vital market in their own right, in conjunction with securitization technology has created a class of products, synthetic structured finance transactions, that have only added to the variety and flexibility available to investors. Credit derivatives have now created for credit as an asset class what an earlier generation of derivatives did for interest rates, to the benefit of cash and synthetic markets alike.

The markets now afford us an almost infinite assortment of structures, applications and asset classes. The different types of originators that have employed securitization, together with the numerous

different underlying assets, should not detract from the fact that all structured finance products are vehicles for more efficient intermediation. They all seek to achieve the same thing: the pooling and redistribution of risk. This is not just credit risk, but also interest-rate risk, currency risk and so on. To that end then, the tools and techniques employed are a positive force in global financial market development.

While in no way an exhaustive or ordered discussion, let us consider now just some of the features of the market that continue to make it an object of interest.

Originator and asset

class diversity

The differing asset classes that have been or, or can be, subject to securitization create a wide choice for investors, but the underlying theme is whether the transaction creates the right risk/reward profile for them. All underlying assets have one thing in common: a value that can be determined and a known or predicted future cashflow. Investors have a wide range of assets to choose from. At heart they require a good understanding of the underlying asset class, and the motivation of the originator. The involvement of service providers and ratings agencies assists in this understanding.

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To the traditional asset classes such as residential mortgages, credit card debt, auto-loan and other receivables can now be added some very exotic asset classes. For example, consider these successful recent transactions:

- Dignity: the whole-business securitization of a funeral homes business;
- Rosy Blue: the securitization of an inventory of diamonds;

What are investors to make of these seemingly wholly different transactions? And these are in Europe; other assets are being securitized across Latin America, Africa, the Middle East and Asia, as well as in North America, where it all began.

We reiterate what we noted at the start: all transactions seek to repackage risk and also more efficiently intermediate between the users and suppliers of capital. Of course investors must seek to

become familiar with the nature of the asset class, but they also must accept the valuation being placed on the asset by the arrangers. What is the motivation behind the deal for the originator? Does the valuation follow sound principles? This is not necessarily a simple or straightforward analysis, but given the right approach and tools, one that can be undertaken satisfactorily.

The range of originators is also growing. To the original banks and mortgage originators we can now add corporates of different types, healthcare providers, utilities and sovereigns. To these originators there is the attraction of (variously) lower regulatory capital costs, diversified and/or cheaper source of funds, and a vehicle whose note liabilities are often given a better credit rating than that of the originator.

Investors benefit from this diversity too, because it becomes possible to structure a risk/reward profile that is more precisely tailor-made. Perhaps the investor wishes to access a specific asset class, to diversify its portfolio mix? Through the use of a repackaging vehicle and the services of the Arranger, this requirement can be met. Perhaps the asset class is better served being accessed synthetically? The route taken can be cash or synthetic securitization depending on originator and potential investor requirements.

Synthetic transactions

Synthetic deals often have administrative and cost advantages over their traditional cashflow cousins, which appeal to issuers and investors alike. The market cost to the issuer – in terms of the liabilities paid by the structure – is sometimes lower in the credit derivatives market than they would be in the cash market, while the vehicle is often able to produce a more attractive risk/return profile for investors.

As the synthetic structure enables removal of credit exposure without asset transfer, it may be preferred for risk management and regulatory capital relief purposes. For banking institutions it also enables loan risk to be transferred without selling the loans themselves, thereby allowing customer relationships to remain unaffected. A synthetic arrangement means that the credit risk of assets that are otherwise not suited to conventional securitization may be transferred, such as bank guarantees, letters of credit or cash loans that have some legal or other restriction

on being securitized. For this reason synthetic deals are frequently more appropriate for assets that are described under multiple legal jurisdictions.

Differences between synthetic and cash CDOs are perhaps best reflected in the different cost-benefit economics of issuing each type. The economic advantage of issuing a synthetic versus a cash CDO can be significant. Put simply, the net benefit to the originator is the gain in regulatory capital cost, minus the cost of paying for credit protection on the credit default swap side. Under Basel I, in a partially funded structure, a sponsoring bank will obtain full capital relief when note proceeds are invested in 0% risk weighted collateral such as Treasuries or gilts. The super senior swap portion will carry a 20% risk weighting. In many cases a synthetic deal would be cheaper under this arrangement.

Another benefit of structuring CDOs as synthetic deals is their potentially greater attraction for investors (protection sellers). Often, selling credit default swap protection on a particular reference credit generates a higher return than going long of the underlying cash bond. In general this is because the credit default swap price is greater than the asset swap price for the same name, for a number of reasons (see Choudhry 2001).

Synthetic CDO notes are examples *par excellence* of correlation instruments. The correlation of underlying or reference assets and its impact on note return is important. The capital structure of a CDO is sometimes adjusted shortly prior to issue to take account of correlation sensitivities. This involves linking part of the return of a tranche to that of the Equity note or another note, so-called "combination structures" or Combo notes, which was first observed in Europe with the Robeco III CSO underwritten by JPMorgan Chase and closed in December 2001 (see Choudhry 2002). The main principle behind a Combo note structure involves restructuring the coupon of a tranche so that a part of the return is linked to the Equity note. This reduces the correlation sensitivity of the Combo note while also increasing the coupon. The Combo note

may pay either a Libor spread plus a variable return based on the performance of the Equity note, or a fixed coupon. The greater the share of the Combo note return that is linked to the Equity note, the lower its sensitivity to correlation.

A Combo note structure offers an alternative

investment strategy for investors, since higher-rated note tranches in a synthetic CDO carry correlation risk, while lower-rated tranches are long of correlation risk. A Combo note retains a higher credit rating, but by linking part of its return to a lower-rated note, its correlation risk is reduced. Just another example of the wide range of investment options available for fund manager consideration.

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Latest developments

That the popularity and attraction of synthetic securitization deals has been, and continues to be, high is not in doubt. Future developments may curb this growth and should, I am sure, task the ingenuity of bankers still further. Certainly, new accounting standards and the impact of Basel II will have a significant impact on the market. Another issue is the continued sourcing of the super-senior piece in synthetic CDO structures. A large part of the superior economics of such deals stems from the low cost of the super-senior swap, which is usually laid off to a monoline insurance company. At the RISK European credit conference in October 2002, one of the presenters suggested that the level of protection offered from this source may be drying up, and that monoline insurance companies may be decreasing the level of their activity in such swaps. Insofar as it happened to any extent, this turned out, so far, not to have a detrimental impact. What would have been its impact? Presumably the arranging investment banks will be left wearing more and more of the super-senior sold protection risk. We could expect the cost of such protection to rise as a result, making the deal economics less favourable. For the market to see the continuation of the rapid growth seen to date, a natural counterparty for the super-senior element, such as insurance companies or fund managers with good expertise in synthetic corporate credits, will

need to be available.

What of Special Purpose Vehicles (SPVs), well-established in the asset-backed markets, and the subject of controversy after the Enron affair? FASB 140 in the United States attracted much comment. Removing the arm's-length regulatory treatment to which SPVs are treated currently will call for new approaches in the structured finance market. However we should remember that Enron was a case of fraud perpetrated on a large scale, and should be treated as a special case. Any structure or set of regulations is going to be shown up as weak or fallible when market participants are abusing them by engaging in systematic dishonest activity. This debate will be running for a while, we can be sure.

The ability of the structured finance market worldwide to tailor structures to meet specific investor requirements is typified by the single-tranche CDO. Put simply, this transaction creates a note, the only piece, that represents a specific risk/reward profile in a pool of synthetic assets. Even the tranche size is determined by the investor, who may specify a particular credit rating or no rating at all. The single-tranche CDO is perhaps the best example of the investment banker's "win-win" structure, with all parties to the deal gaining from their involvement. The investor is able to generate the transaction itself, by specifying its requirements to the arranging bank. The single-tranche CDO demonstrates brilliantly the coming-together of market flexibility and investor demand; it would not have been possible without a liquid market in credit derivatives. It is a good example of leading-edge market development.

Another recent development is the synthetic repack, of an existing cash or synthetic investment or risk exposure. What about a "win-win" that meets client investor requirements by repackaging an existing holding that a bank has in a CDO mezzanine note or junior credit default swap? The bank wishes to remove its credit risk exposure via an SPV, and so creates the repackaged security as a credit-linked note, sold to the investor who desires this particular risk/reward profile.

Credit derivatives have enabled non-bank financial institutions to access the money markets where

hitherto this would not have been possible. It is the synthetic asset-backed commercial paper conduit structure that has made this possible. In essence, in this structure a total-return swap replaces the previous liquidity back-stop or sponsor guarantee. Fund managers or the hedge fund subsidiaries of

banks are potential users of this arrangement. The conduit market presents many flexible and tailored solutions for originators, with investment banks offering platforms that can take specific parts of clients' asset pool off the balance sheet, while reducing costs for smaller originators. In the meantime money market investors have an additional class of issuer names

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to consider.

The foregoing is only a small fraction of what is out there, and hopefully gives some flavour of how exciting the industry is. As Sir Arthur Conan Doyle would have put it, endless delicious minutiae for us to consider...

Let us continue to observe the market.

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