Securitisation

Richard Senior sheds some light on this ubiquitous, yet oft-misunderstood, term and shows how firms are using securitisation for financing and risk management.

Securitisation: it's really factoring, isn't it? Only the largest companies can do it, right? Wrong on both counts.

Let's start with what securitisation does: it takes pools of illiquid assets and turns them into liquid securities – hence the name. "Liquid" usually means rated by one of the big rating agencies: Moody's, Fitch or Standard & Poor's. Once you've got rated securities, you can fund in the capital markets, which means issuing rated bonds (long term) or commercial paper (short term). One of the key advantages of these so-called asset-backed securities (ABS) is that you can borrow directly from the capital markets, disintermediating banks.

The market for such securities is large and growing. ABS bonds issued last year were worth $797bn (£419bn) in the US and €408bn (£282bn) in Europe. The amount of commercial paper issued exceeded $1trn.

What sorts of assets can be securitised? The pie chart below shows that the most popular asset class is mortgages, accounting for 58 per cent of the market. This is because they possess the attractive characteristics of comprising many small individual assets and having a clear payment history, which makes ratings easier to obtain. But the same process applies to assets such as the commonly seen leases, trade receivables and loans, as well as to more exotic assets, such as football ticket receivables, life insurance risk and champagne stocks. These have all been securitised. As a general rule, if you have an asset class that can be analysed statistically, you have a fair chance of securitising it.

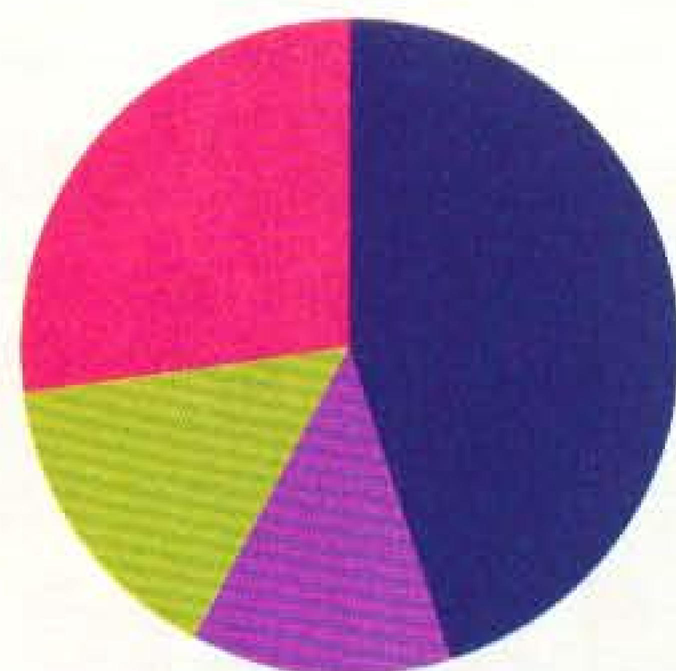
Although the principle of securitisation is straightforward, putting it into practice is not. It's much easier to enter into a lease or to take out another bank loan. For a company, there are two main reasons why securitisation is worthwhile:

- Cost of funds. ABS sell in the capital markets at attractive rates: the highest-quality (AAA-rated) bonds currently trade at around Libor plus 10 to 20 basis points (hundredths of one per cent).
- Alternative funding. A company that doesn't have a rating can access the rated markets via ABS when it can't do so in its own name.

Some firms have other motives for securitisation. These include off balance sheet treatment (which I think isn't a good reason) and risk management: if you have sold assets, you can't lose more than the so-called retained risk, which varies between 1.5 per cent of the pool for mortgages and about ten per cent for trade receivables. Compare this with factoring/invoice discounting, which has full recourse to the company.

Banks have more reasons to securitise, particularly under the Basel I regulatory regime. In crude terms, this requires that corporate risk be backed by eight per cent capital, mortgages by four per cent and banks by 1.6 per cent. This means that a loan to, say, Shell requires five times more capital than a loan to the worst bank in the EU. That, of course, makes no economic sense. Taking the biggest asset class, mortgages, as an example, isn't it better to use 1.5 per cent capital rather

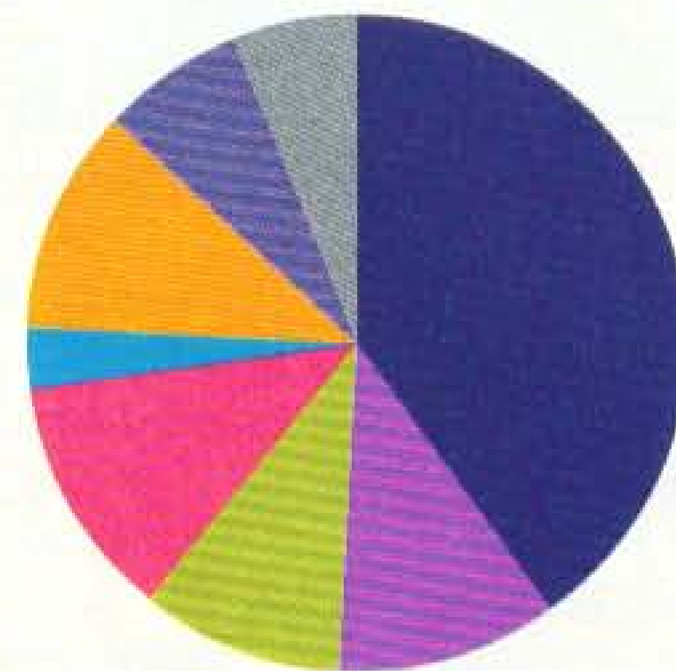
ASSET TYPES SECURITISED IN THE EU, 2005



- Residential mortgage-backed securities – ie, loans to homeowners.
- Commercial mortgage-backed securities – ie, loans against shops etc.
- Collateralised debt obligations – usually pools of loans or bonds.
- Asset-backed securities – everything not included in the other categories.

Source: Robin Hood Finance

SECURITISATION DEALS IN THE EU, 2005

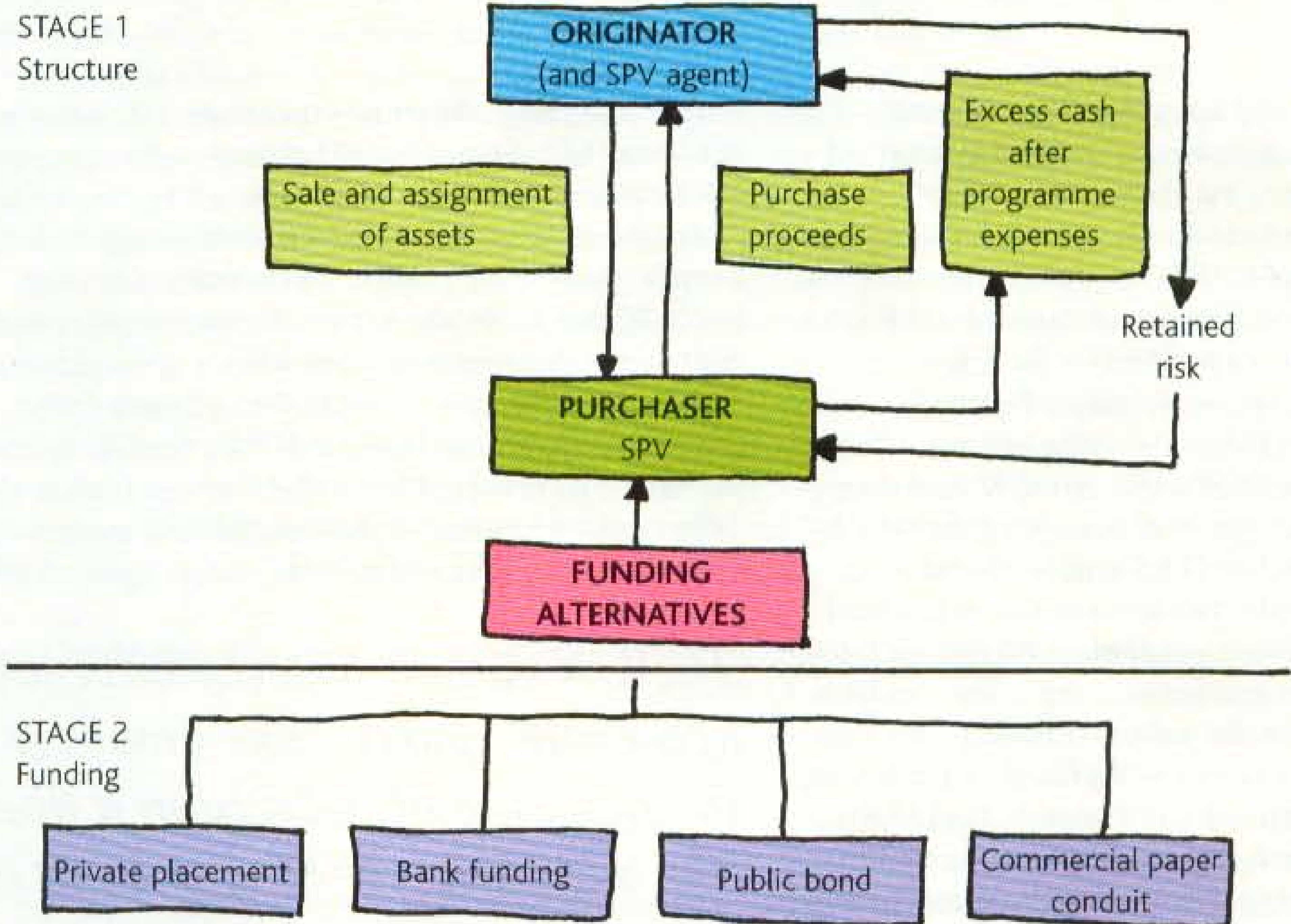


- UK.
- More than one nation.
- Italy.
- Spain.
- France.
- The Netherlands.
- Germany.
- Other.

Source: Robin Hood Finance

HOW DOES IT WORK?

A pool of assets is identified and sold to a special purpose vehicle (SPV), which is there to ring-fence the assets. The assets are then analysed according to rating-agency principles into separate tranches with different orders of priority of payment. In a company, this would be called senior debt, subordinated debt and equity. In securitisation, there are many more levels of rating, from AAA down to CCC. Part of the skill in securitising is to set these tranches in the most efficient proportions.



Source: Robin Hood Finance

than four per cent? You can book nearly three times as many loans for the same amount of capital, which is an excellent strategy if return on equity is your key driver. This is a business model that has helped credit card firm MBNA to catch and overtake many conventional banks.

HBOS securitised £10.9bn of mortgages in 2005 and other banks are pushing this efficient approach even further. Both WestLB and Investec Bank have set up new units to originate mortgages with the sole purpose of securitisation. In this way, ABS have moved from being a passive tool to an active driver of business.

The bank capital treatment of ABS bonds (eight per cent capital) also explains why so many banks have set up repackaging vehicles to buy ABS bonds and fund them via commercial paper. This requires virtually no bank capital, compared with eight per cent. Many ABS bonds end up in these vehicles.

Trade receivables are the biggest asset class originated by companies. There are currently more than €40bn (£27bn) of these funded via securitisation in Europe. This is much larger than the UK factoring market (£11bn), but less well known. Trade receivables securitisation was once usually a £50m-plus-per-deal market, but legal and technological advances have made much smaller deals viable. In Germany last year 33 such deals were completed, 26 of which were worth less than £50m.

Even quite highly geared companies can use this method of raising funds. I work with one company that specialises in refinancing leveraged buy-outs via securitisation, often saving more than one per cent in funding costs.

Who invests? As well as the bank vehicles, there is a ready market for rated bonds and commercial paper among investors worldwide, including pension funds, insurers and cash-rich companies. All of these have liquidity that needs to be invested efficiently and they use the ratings to filter their choices. There are so many possible investments that they wouldn't have time to do ground-up analysis on each opportunity.

There is also typically a higher yield from ABS than from corporate bonds, leading to the counter-intuitive situation (in current markets) of ABS offering a higher yield for lower risk. This is partly because there are still many investors who are unable or unwilling to invest in ABS, which their institution sees as comparatively risky or complicated, and partly because bank issuers are pricing at least to some extent based on the capital they are freeing up, not only on debt cost in isolation.

In summary, securitisation is based on statistical analysis and involves benchmarking by means of a rating to satisfy capital market investors. This gives access to a large pool of competitive funding. It can be used for existing assets, or as part of a business model to drive which assets are originated, rather than the traditional model of originating assets and sorting out the funding later.

As a rule of thumb, it's worth baring in mind that securitisation is simple, but it's not easy. FM

Richard Senior ACMA is the founder of Robin Hood Finance, a firm of securitisation advisers, arrangers and trainers (www.robinhoodfinance.com).