Securitisation
Key
Concepts

What's it
all about ?

Securitisation Foundation

PCS

Securitisation Key Concepts

What's it all about ?

The heart of all securitisations lies in two key concepts:

- Asset-only risk
- Tranching

Securitisation Key Concepts

Asset-only risk

- Securitisation is NOT secured finance
- A securitisation investor ONLY takes the risk of the securitised assets
- If the assets perform, the securitisation investor is paid back
- If the assets do not perform, the securitisation investor suffers those losses
- For a financing to be a securitisation, the two points above must be met EVEN if the bank that originated the assets has defaulted, is insolvent or even is liquidated

Securitisation Key Concepts

Pass-through & match funding

Securitisation being an asset-only risk leads necessarily to another key aspect of securitisations: “**pass-through**”

Pass-through means that the investors in a securitisation can only look at the asset to be repaid (asset-only risk), not the ***originator***

Pass-through means that the investor only gets paid when the securitised asset pays. In some cases (e.g., mortgages and credit cards) this is unpredictable

For the ***originator*** *that means that funding is matching the repayment profile of the assets.* ***No funding miss-match****. This is known as “****match-funding****”*

So, in securitisations usually, the **investor** does **NOT** have a bullet repayment at maturity and may not know exactly when he is going to get paid

Securitisation Key Concepts

True sale

Securitisation being an asset-only risk leads necessarily to another key aspect of traditional securitisations: "true sale"

"true sale" means that the investors in a securitisation get repaid even if the originator goes bankrupt

If the securitised assets were only security, all jurisdictions have rules suspending the enforcement of security. This would mean that, in the bankruptcy of the originator, securitisation investors may not be able to get their hands on the securitised assets and so would be dependent in some way on the originator to get repaid

So, to be an asset-only risk, the securitised assets are sold by the originator in a "true sale" that will be recognised by the courts even if the originator is bankrupt

Securitisation Key Concepts

Asset-only risk & true sale give you

The SPV

"**True sale**" requires the securitised assets to be sold by the originator to avoid being trapped in the originator's bankruptcy

But where do you put the assets now you have sold them? Who is buying them?

The ***special purpose vehicle (SPV)*** is a corporate entity set up just for the securitisation and has the following characteristics:

No employees	No other activities	Tax neutral	Independent

This makes it ***insolvency remote***

Securitisation Key Concepts

Tranching

Securitisations are "*tranched*": the risk of the securitised assets is divided in horizontal slices

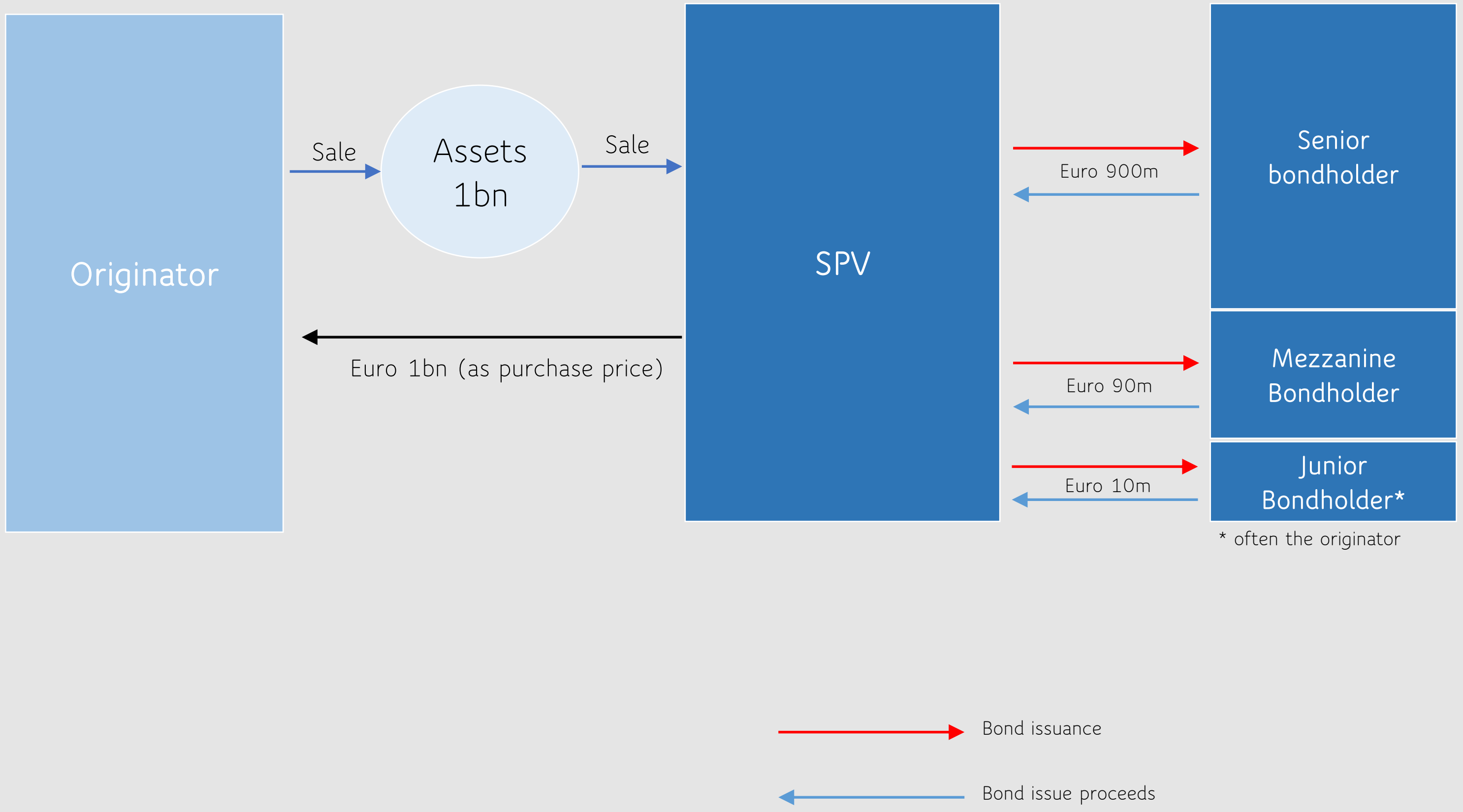
The assets securitised are *pools* of multiple single financial assets

Tranching means that the financing of the pool of assets is made up of different debt instruments ranked by seniority.

The way they are ranked by seniority is that, if defaults happen to the underlying securitised pool, the investors in the lowest ranked debt absorb those losses first, until they are wiped out. Then losses are absorbed by the next highest "tranche" of debt

Securitisation Key Concepts

Tranching
The Classic



Securitisation Key Concepts

Tranching

In the example, the investor in the senior tranche will not lose money unless more than 10% of the underlying assets have defaulted

A credit analysis of the underlying pool will tell the investor how likely or unlikely a 10% loss would be

If a 10% loss is extremely unlikely, the senior tranche is extremely safe and so the senior investor will accept a low return (interest rate) to reflect the safety of the tranche

So, another **securitisation rule:**

"the lower the tranche in the stack, the higher the risk and so the higher the interest rate"

Securitisation Key Concepts

Tranching WARNING!

Despite how it is sometimes presented, **securitisation is not alchemy**

Securitisation **cannot turn lead into gold** or high credit risk into low credit risk

The **total risk of a pool** of securitised assets **remains the same**

If you add the credit risks borne by the senior bondholder, the mezzanine bondholder and the junior bondholder, it sums to the exact same credit risk of the pool

But if you think of the pool as a mixed lot, securitisation **can separate the gold** in the pool **from the lead** in the pool

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The Waterfall

- As cash is generated from the securitised assets and received by the SPV, it is distributed in a specific order. That order is the "waterfall"
- **The archetypal waterfall looks somewhat like this:**
  - ❖ Entities that have to be paid if the securitisation is to continue (servicing fees, swap fees, admin expenses…)
  - ❖ Liquidity fees
  - ❖ Swap payments
  - ❖ Most senior noteholders
  - ❖ Mezz noteholders
  - ❖ Junior noteholders
  - ❖ Excess spread to the originator
- This is an idealised list and waterfalls can be quite complex
- There are usually two waterfall – interest and principal
- There can also be two waterfall – pre and post enforcement

Securitisation Key Concepts

Liquidity

- The cash flow from the assets may suffer for irregularities over time when the securitisation bond must pay in accordance with its schedule eg consumers paying late
- To prevent asset cash flow irregularities resulting in the technical default of the securitisation bond, a bank may provide a committed loan facility to the SPV to be drawn on in case of a cash shortfall. This loan is a "liquidity facility"
- Because the liquidity facility is liquidity not credit support, it gets repaid before the securitisation notes in the waterfall

Securitisation Key Concepts

The Servicer

- The SPVS is insolvency remote so has no employees
- Someone has to service the assets – collect cash, send chasing letters, enforce defaulted receivables
- The "servicer" is usually the originator but not always
- Sometimes a party is appointed upfront in case the servicer is not capable of acting – this is called a "back-up servicer"

Securitisation Key Concepts

Warehouse Facility

- There is a minimum size for a securitisation placed in the public markets
- So how does a non-bank finance the original lending to create the assets that will go in the securitisation pool?
- One financing tool is a committed loan facility from a bank which is itself a securitisation (ie asset backed and tranched). These are called "warehouse facilities" or just "warehouses"
- A customer borrows from the originator eg for example a house purchase. The originator draws down on the committed loan facility in the amount of the mortgage and advances the funds.
- There is an agreement between the lending bank and the originator that when a certain amount of origination has been reached, the originator will refinance the pool via a securitisation
- Because warehouses are legally securitisations, they must comply with the Securitisation Regulation
- The capital that must be allocated by the lending bank is the CRR required capital for a securitisation
- But that means that warehouses can also achieve STS status and a lower capital allocation as a result

Securitisation

Why do it if you are an originator?

Asset-only means securitisation is a form of **financing** ***accessible*** *even when the bank is weak or in danger*

Asset-only means that for a weak bank with strong assets, the ***cost of financing can be lower***

Tranching means that the bank using securitisation can **access** ***new investors*** that would not finance it on an unsecured basis

Tranching means that, by targeting specific investor groups and appealing to their specific risk/reward targets, *the* ***total cost of funding may be lower*** than without tranching

If the **investors take the asset risks**, it means that those risks are **not borne by the originator** and therefore **no capital need be set aside against those assets** – securitisation can be *a* ***capital management tool***

Securitisation

Why invest into it?

Tranching means that securitisation can create **high quality capital market debt** from mixed quality assets for risk averse investors seeking a good return

Asset-only finance means that capital market **investors can lend** (indirectly) and take the risks of **markets to which they have no other access** (e.g., SMEs or residential mortgages)

The European nature of the market means **investors** can have **access to safe capital market instruments in jurisdictions** to which they have **no other access**

Because **rating agencies allow senior tranches** of securitisations to be **rated higher than the sovereign**, securitisation allows low risk investors to invest in high-risk countries