# Chapter 1

# Introduction

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## 1.1 The market

The securitisation market developed in the US, eventually transferred to Europe and is now growing in almost all regions of the world. Few financial managers or professionals will not come across securitisations at some point in their career. The tables below demonstrate the volume of transactions in the market, diversity of assets involved and geographic spread. What is not obvious from the pure numbers is that this is a market used by non-rated privately owned companies, through highly rated major financial institutions to governments themselves.

***Table 1.1: European Securitisation Issuance Through Q1 2005 by Country of Collateral***

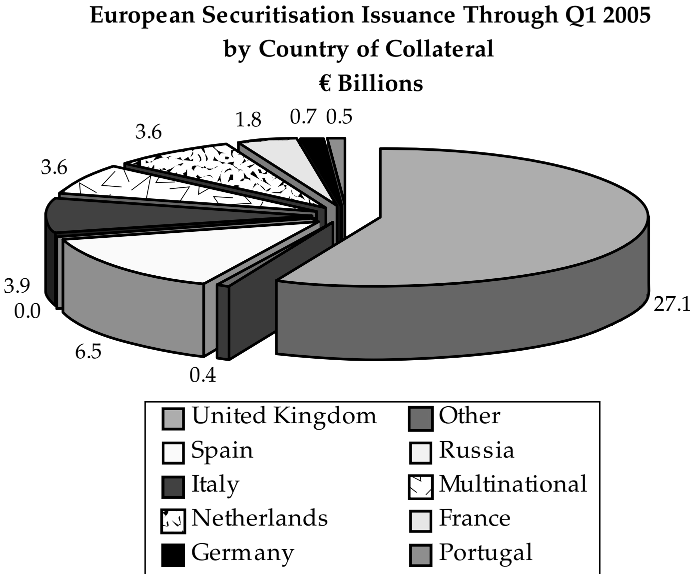
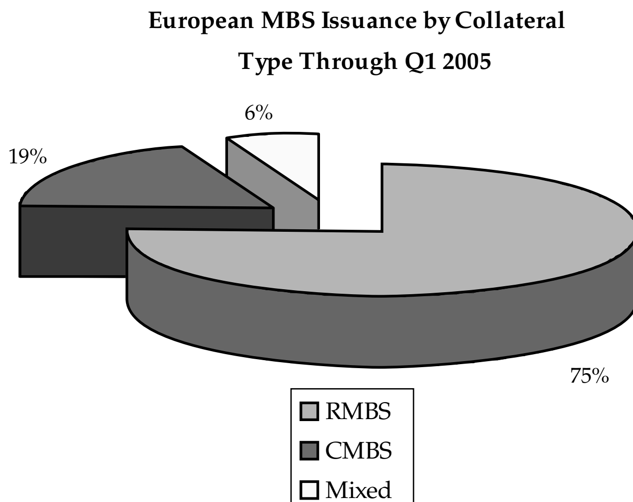


***Table 1.2: European MBS Issuance by Collateral Type Through Q1 2005***




Source: European Securitisation Data Report, Spring 2005

## 1.2 What is securitisation?

Securitisation at its simplest is a secured borrowing, whereby a company borrows against an asset or group of assets. In a normal secured borrowing the repayment of the funds is secured by a security charge over the charged assets and in the event of liquidation of the lender receives repayment from the sale of the assets by the receiver or administrator. In a securitisation, the assets at the outset are "moved" into a separate company distinct from the originator of the assets ("special purpose entity ('SPE')") and, in the event of problems with the ultimate borrowing company, the lenders can take control of the company and assets and administer them in the best way so as to ensure repayment of their loan.

Because the assets have been "ring fenced", the borrowing company or "originator" has transferred some of the risk of those assets and historically has been able in some cases to remove them from its balance sheet. This would often improve its financial ratios and standing.

Lending to the SPE takes the form of bonds, bank loans, or commercial paper ("CP"). The funding may be raised on a bilateral basis with a bank, in the public debt markets or through a bank's financing conduit.

Depending on one's perspective, therefore, securitisation is either a specific funding mechanism, or a technique for transferring risk from the funded assets, giving rise to the "off balance sheet" label.

Other benefits that could result from a securitisation include:

- cheaper funding than the originator could raise directly;
- capital relief for regulated entities;
- an "exit" strategy for an originator of assets;
- providing a liquidity facility.

Undertaking a securitisation often also results in enhanced systems and a better understanding of the originator's processes and the quality of the assets originated.

These benefits are discussed more fully in Chapter 2.

Securitisation techniques have in recent years developed so as to give originators the option of risk transfer without funding ("synthetic securitisation"). Investment banks also use the techniques to structure tailored investment products for investors through Collateralised Debt Obligations ("CDOs").

## 1.3 Basic structures

A number of different structures will be discussed in later chapters, but fundamentally they fall into the three categories referred to above: funded structures, synthetic securitisations and Collateralised Debt Obligations ("CDOs").

### *1.3.1 Funded structures*

These form the bulk of the market and provide an originator with both funding and risk transfer. Some countries have specific regulations which influence how a funded securitisation is structured, but the basic structure is shown in Figure 1.1.

***Figure 1.1: Structure of funded securitisations***

In this case, the assets are ring fenced in the SPE, which usually is not owned by the originator but by a trust or fund. The purchase of the assets is funded through bonds or CP. To ensure repayment of the funding, even if some assets default, "credit enhancement" is provided. This credit enhancement allows for the rating agencies to rate the funding at a high rating, typically AA and above.

Credit enhancement may take the following forms:

- subordinated debt from the originator;
- over collateralisation, where assets are sold to the SPE for a discount;
- reserve funds where cash is captured in the SPE for a period of time;
- external insurance or guarantees.

Cash flows from the assets are collected by the SPE and passed to investors as interest and to repay the funding. Payments are either made as they occur (a "pass through structure") or collected by the SPE and paid periodically (a "bullet structure"). Repayment of funding is dependent on cash flows from the assets and any credit enhancement provided.

Another common feature is a revolving facility whereby funds collected from the assets, after interest payments, are used to acquire further assets from the originator for a period of time.

Swaps would also be put in place with the SPE to cover interest rate risk and currency mismatches that may arise between the currency of the assets acquired and the currency of the funds obtained.

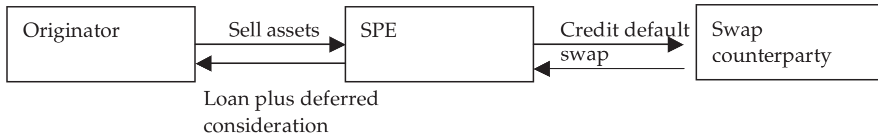
The priority of paying cash out to the various parties is known as the waterfall.

Any cash left over from the assets after interest and capital repayments, known as excess spread, is returned to the originator.

### *1.3.2 Synthetic securitisations*

Synthetic securitisations do not provide funding, but do provide an element of risk transfer. They are attractive to those who can already fund easily and effectively, but want to protect themselves against some of the risk of the assets without selling them. The basic structure is as shown in Figure 1.2.

*Figure 1.2: Structure of synthetic securitisations*




In this structure the assets are again ring fenced, and then a credit default swap put in place. The credit default swap pays any losses arising from the assets, usually after a predetermined amount, known as the first loss, in return for a fee. It is in many ways akin to an insurance contract. The credit default swap can usually be tailored to absorb whatever risk the originator wants to transfer.

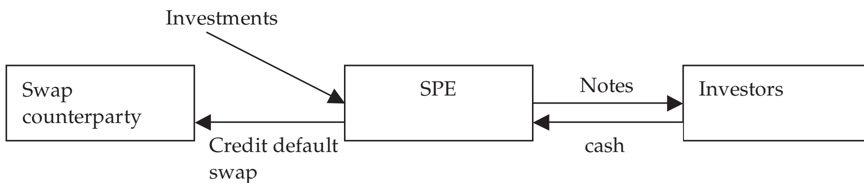
As cash is received from the assets they go to the originator to repay its loan and any excess as deferred consideration for the sale of the loans.

### 1.3.3 CDOs

Unlike funded and synthetic securitisations, which tend to be originator-driven, CDOs tend to be investor-focused and set up, usually by investment banks or fund managers, to provide investors with the type of investment and exposure that meets their requirements.

The basic structure is shown in Figure 1.3.

*Figure 1.3: Structure of CDOs*




The investors' notes provide a return based on the performance of a set of exposures and generally are greater than an investment in highly rated investments such as government bonds. These exposures are placed into the SPE by purchasing them in the market ("funded"), or through a credit default swap ("unfunded"). Any residual cash in the SPE is invested in highly rated investments.

The return to pay to investors is obtained by the SPE from interest and dividends earned from its investment portfolio and the premium paid for the credit default swap. If an exposure defaults, investors lose both interest and capital.

In a managed CDO the exposures are actively managed by an investment manager.

## 1.4 The parties involved

As will be seen in later chapters, a securitisation is a complex process involving many parties. Whilst it will provide a range of benefits, these need to be weighed against the costs involved – both internal and external.

In outline, the following parties will be involved in a securitisation:

- Lawyers – There will be a range of legal documents to prepare including an asset sale agreement, servicing agreements and prospectus, if a public bond issue. The lawyers will also handle the setting up of the SPE and obtaining the listing if required. In a public bond issue, independent lawyers will act for the sponsoring investment bank; in the case of a bank conduit, their lawyers will handle the funding aspects of the securitisation. The role of lawyers is fully explained in Chapter 4.
- Investment bankers – In a public bond offering they will be involved in issuing the prospectus and distributing the bonds, which they may underwrite. To enable them to do this they will need to be involved and satisfied with the structure of the securitisation. They may also be involved in the rating process.
- Rating agencies – A key part of producing an efficient securitisation is obtaining a satisfactory rating for the bonds with the minimum amount of credit enhancement. The rating agencies will examine the asset pool and structure of the securitisation to determine an appropriate rating. Further consideration of the rating agency approach is set out in Chapter 8.
- Accountants – The accounting for a securitisation may be important for a variety of reasons, including regulatory capital and taxation; it is therefore usual to obtain an accounting opinion. Details of the accounting approach for securitisations are given in Chapter 5.

  Accountants will also usually provide comfort and accountants' reports on information in the prospectus. They will often undertake

due diligence procedures on the asset pool itself. This is expanded further in Chapter 3.

- Tax advisers – Tax plays a significant part in most securitisations as it is important to minimise both the tax effects of the sale of assets into the SPE and of the securitisation overall. Normally, it is possible to structure the SPE so that it has no taxable profits. VAT on services provided to the SPE needs to be carefully looked at, as do any cross-border impacts. Taxation considerations are more fully explained in Chapter 6.
- Servicers – In many cases, the originator will continue to service the assets, including collecting payments and handling customer correspondence within agreed parameters. However, a back-up servicer may need to be put in place who can take over servicing in the event of default by the originator.
- SPE managers – As the SPE is independent of the originator, it will need independent directors and various management services. There are a number of specialist companies who provide these services in various locations.
- Trustees – With a public bond offering, a trustee will be required to represent the bond holders' interests and administer the security if required.
- Regulators – If a securitisation is being undertaken to obtain regulatory capital relief then the regulators' rules will need to be complied with and their approval obtained.
- Investors – Finally, but most importantly, it is the investors who will provide the funds. It is usual for investor roadshows to be undertaken before a securitisation is launched. Also, ongoing investor reporting will be required by the SPE, and this is usually provided by the servicer. This is discussed in Chapter 9.

In the following chapters the process of securitisation will be described in more detail, looking at both the roles of the various parties and the issues with which they are concerned.