How secure is the future?

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Has securitisation had its day? Though the markets may change, William Ross of ABN AMRO says the story is far from over.

As a backdrop to the changes across Euro-pan mortgage markets during the 1990s, there has been a long-running debate between "American" and "European" styles of securitisation. Waving the Stars & Stripes, residential mortgage-backed securities (RMBS) have been feted as tools for regulatory capital management but decried as an expensive source of funding.

In contrast, covered bonds are justifiably toasted with fine Rieslings as attractive funding instruments, but are open to criticism for structural rigidities and a lack of de-linkage. Perhaps due to the intensity of their debate, proponents on either side of the argument failed to notice the mid-Atlantic courtship that has resulted in Structured Covered Bonds. Curmudgeons in either camp aside, the market has welcomed the new instrument with open arms. But with their success, what is the outlook for (American style) securitisation?

Given Basel II's emphasis on reducing the incentive for regulatory capital arbitrage, questions about its continued relevance have already been raised. Despite the recent years of strong growth, will the emergence of a superior funding instrument in the Structured Covered Bond speed its demise?

The message of the medium

The simple answer to the question is that securitisation is unlikely to totally disappear as there are numerous issuers that are unaffected by the change in the regulatory regime. As such, it is reasonable to expect that finance companies and the public sector will continue to securitise.

Though likely to prove true, this is not a satisfying answer as the bulk of European supply has come from banks. We, at ABN AMRO, believe a more revealing answer to the question can be found in looking at the motivation behind transactions. Bear in mind that securitisation is not an end in itself. It is just one of the many options in the financial tool-kit. Like any other tool then, securitisation is only useful insofar as it can be employed successfully to meet its users' needs. Consequently, what is more important than securitisation as a medium is the end to which it is deployed. Due to the basic flexibility of securitisation as a methodology or mechanism, its use is in many ways only limited by the financial engineer's imagination.

Diverse objectives

Regulatory capital arbitrage may be a common objective for bank issuers but there are many others. They include funding, a source of diversification, asset and liability management, risk transfer, balance sheet optimisation, and the capture of an arbitrage. Proof of this diversity of objectives can be found in Graph 1 in the range of secured assets.

Further, few transactions aim to achieve only one of these ends. Most work towards various complementary goals within a single structure. This is at odds with the view that
securitisation will wither away under Basel II, which presumes that regulatory capital arbitrage is the sole motivating factor for bank issuers. Even in Europe, where it has been a driving force in growing the market, this is rarely the case. Thus, while banks may no longer have an incentive to securitise for regulatory capital purposes, there are numerous other reasons for which they could choose to employ the technology.

Incentive to securitise

Simple words, soundly reasoned but still not a totally satisfying response. So let us be provocative for a moment. Does Basel II really remove the incentive to securitise for regulatory capital arbitrage? Like most great questions in life, the answer depends on where you are standing and at what you are looking. If a bank is able to align regulatory with economic capital internally why should it securitise?

The answer is that incentives may continue to exist within the new regime. First, the degree to which regulatory and economic capital can be aligned depends upon the methodology used to calculate the risk weighting of assets. Where you are standing in this regard differs greatly if a bank is on the standardised approach, or if it qualifies for either of the two internal ratings based (foundation and advanced) approaches.

Risk rewards

It has always been the Basel Committee’s intention to reward banks for the sophistication of their internal risk management. The Committee’s third quantitative impact study (QIS 3) confirmed the virtuous vector of successively lower capital charges for the same pool of assets by moving from the standardised approach through the two internal ratings based (IRB) approaches. The extent to which this is possible depends upon what asset you are looking at. While the regime heavily favours granular consumer exposures, it treats unrated corporate exposure far more harshly.

Transaction innovation

We attempted to quantify these differences using an ABN AMRO transaction as an example. Priced in December 2001, SMILE Securitisation Company BV securitised a €5bn portfolio of loans to Dutch small and medium-sized enterprises (SMEs). Investors welcomed the transaction, and lauded it with awards for innovation. From ABN AMRO’s perspective, the transaction sought to release the maximum amount of regulatory capital against its SME portfolio, a fact explicitly reflected in the transaction’s structure. Namely, ABN AMRO broke from the common practice of retaining the first loss piece (the equity tranche) in the transaction and sought to fund it instead through excess spread.

Excess spread is the difference between a portfolio’s yield and its financing costs. It is the primary form of credit enhancement in a securitisation, with losses first met through excess spread and the reserve account before the rated tranches. Generally, if excess spread is not used to meet losses, it is released back to the holder of the first loss piece. This residual income stream is analogous to a dividend payment to equity holders, and has been the incentive for originators to hold the first loss piece in their securitisations.
Maximum relief

Holding the first loss piece, however, results in a one for one capital charge. Thus to maximise its regulatory capital relief, ABN AMRO opted for the excess spread option through which the reserve account was to grow from 0% to 1% of the portfolio. The remainder of the transaction’s capital structure was made up of 86.4% triple-A, 5.2% double-A, 4.8% single-A, and 3.6% triple-B rated notes. Crucially, all rated notes in the transaction were sold to investors. ABN AMRO did not retain any direct balance sheet exposure to the deal.

Using the Basel Committee’s proposed methodology, ABN AMRO modelled the capital requirements for the securitised portfolio under the three risk-weighting regimes. We made a few assumptions to simplify the process and so these should not be taken as official measures. They are precise enough, however, to use as a basis from which to draw some conclusions. Graph 2 modelled the capital requirements for the transaction as executed. In it we can see the virtuous vector of how the capital held against the portfolio prior to securitisation decreases as risk management sophistication increases. As such, though securitisation continues to release capital in each scenario, its efficacy decreases.

Surprisingly, even when calculated using advanced IRB, the securitisation results in a 67% release in capital. This is a substantial release of capital by any measure, and demonstrates that Basel II does not entirely remove the incentive to securitise. In this case, it is due to the treatment that SME loans receive from Basel II and the fact that ABN AMRO did not retain any direct balance sheet exposure to the transaction.

Conventional option

But what if ABN AMRO had opted for a more conventional structure and retained both the first loss piece and the most junior tranche of rated notes, the 2.5% triple-B piece? Graph 3 clearly demonstrates the substantial difference this makes. Due to Basel II’s tough treatment of first loss and mezzanine securitisation exposures, the ability to release capital almost entirely disappears under advanced IRB. Under the standardised approach, however, substantial capital relief remains possible. This difference highlights how a bank’s specific circumstances (in terms of assets and risk weighting methodology) will determine the continued relevance of securitisation as a capital management tool.
### Change ahead

While the sceptic may begin to accept our words on securitisation’s continued relevance, even the true-believer must concede that the securitisation markets are set to change over the foreseeable future. At ABN AMRO, we believe that these changes will be in the form of assets securitised, structures employed, and regions of issuance.

Returning to Graph 1, we find that, to date, residential mortgages have made up an overwhelming portion of new issue supply. Given that these are precisely the sorts of assets that Basel II favours to be retained on balance sheet, the low risk weighting they will receive on balance sheet (particularly under advanced IRB) will result in little incentive to securitise them for capital purposes. The market recognises this and there are already expectations that RMBS volumes from bank issuers will wane in the run-up to Basel II. This is particularly true due to the strength of the structured covered bond as a funding tool.

Consequently, we expect the emphasis in regulatory capital securitisations to increasingly shift towards corporate assets. While balance sheet collateralised debt obligations (CDOs) have long been common; they have traditionally focused on high-grade assets due to their relative capital inefficiency. We expect this to change, with unrated corporate exposures coming to the fore. As this will make balance sheet CDOs look more like arbitrage transactions, it remains to be seen how the market will respond.

As for structure, we believe that the differences between Graphs 2 and 3 point us in the direction of change. Namely, there will be an increased incentive to distribute the equity in transactions to be able to benefit from capital relief. This is in keeping with changes in accounting regimes (FIN 46 and IAS 39) that introduce the concepts of primary beneficiary or continuing interest as the touchstone for re-consolidation. This is a crucial point, as regulators typically require accountancy off-balance sheet treatment before granting capital relief.

### Investors look further

Are there buyers for the equity risk in securitisations? In a word, yes. The increasingly expensive markets in consumer asset securitisations have prompted investors to look further and further down the credit curve. The move into equity is the final stage in this evolution. We have already seen some test transactions, and believe it to be only a matter of time before the market flourishes and develops commodity characteristics. Remember, as recently as three years ago triple-B RMBS exposure in Europe was considered exotic – this is now typically the most heavily bid tranche in a transaction.

Ultimately, both graphs demonstrate the difference the risk weighting methodology makes. This is a competitive issue as a bank on the standardised approach is structurally disadvantaged against a competitor using advanced IRB.

### Securitisation solution

A compelling criticism of Basel II is its American/Euro bias towards rated exposure and extensive performance information. This does not reflect the reality of many Asian and Latin American banks. Given that a large number of these regions banks are likely to end up on the standardised approach, we expect them to turn to securitisation to remain...
Put differently, will it be cheaper to invest in risk management technology or securitise to narrow the capital differential? Though we opened with a debate between American and European securitisation, we may find that it is ultimately the emerging market variant that prevails.

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