Asset Backed Securities

**Asset Securitization: Cost-Benefit Analysis**

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**Benefits to the Investor?**

- Lower risk than corporate debt
- Choice of risk/return levels
- High level of disclosure
- Identifiable assets -- no event risk
- Ongoing monitoring
**Benefits to the Seller?**

- Capital requirement reduction
- Service fees
- Excess servicing fees, which depend on keeping default losses and other costs low

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**Potential Benefits to Investors**

- Investors can achieve
  - Superior return.
  - Liquidity.
  - Diversification.
  - Event risk reduction.
  - Overcome constraints
- But
  - ABS are more complex
  - Some risks remain, such as prepayment risk
Benefits to the Seller?

- Capital requirement reduction
- Service fees
- Excess servicing fees, which depend on keeping default losses and other costs low

But...does the originator’s asset quality deteriorate as a result of the asset securitization?
  - Some of best assets sold
  - Retained 5.5% of assets, subordinated
  - Excess service fees depend on defaults

Potential Benefits to Corporations

- Removes assets from the balance sheet.
- Lower-cost financing.
- Retains competitive advantage.
- Nondisclosure.
- Recognition of gains (or losses).
- Improves asset/liability management
- **But: it is more complex, and there are up-front costs**
**Potential Gains to the Economy**

- Capital market development
- Source of funds for banks, finance companies and industrial companies
- Expanded source of financing for residential home ownership
- Potential for financing of infrastructure projects
- Cost savings to borrowers (e.g., 0.5% of the consumer finance market)

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**Separation of Two Businesses: Origination and Lending**

[Diagram showing the separation process involving sponsoring company, special purpose vehicle, accounts receivable, and asset-backed certificates]
Asset securitization makes sense when the assets are worth more outside the company than within. But what makes them worth more outside?

For Banks: Capital Requirements

- In a perfect world, adding good assets would require little additional capital, since creditors would not see any increase in the bank's risk.
- But if regulatory capital requirements penalize banks for holding such assets, they should:
  - securitize the good assets
  - profit from origination and servicing
- In general, regulatory costs or rigidities create an incentive for banks to shrink their balance sheets by securitizing loans.
A Bank’s Capital Savings

<table>
<thead>
<tr>
<th>Securitization Cost-Benefit Analysis (for a regulated financial institution)</th>
<th>Gain/cost ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funding cost savings</td>
<td>Two-year bank notes vs pass-through rate</td>
</tr>
<tr>
<td>Upfront costs</td>
<td>Underwriting, SEC filing, legal fees, etc</td>
</tr>
<tr>
<td>Ongoing costs</td>
<td>Letter-of-credit fee</td>
</tr>
<tr>
<td>Capital charge</td>
<td>Cost of capital at 25% (15% after tax)</td>
</tr>
<tr>
<td><strong>Net benefit</strong></td>
<td></td>
</tr>
</tbody>
</table>

For Corporations: “Pure Play” Argument

Separate the credit of the assets from the credit of the originator:

- Identify and isolate good assets from a company or financial institution
- Use those assets as backing for high-quality securities to appeal to investors.
- Such separation makes the quality of the asset-backed security independent of the creditworthiness of the originator.
Sears: Asset-Backed Financing?

The Keys to Successful Asset Securitization

- The economic elements that make this technique work are
  - to isolate the assets, thus making them more identifiable, secure and liquid,
  - to transfer risks to those best able to evaluate and bear them, and
  - to create tradeable securities
- Adds economic efficiency through cost savings to borrowers, creation of investment opportunities for investors, and development of the capital market.
**Prerequisites to Successful Asset Securitization (cont.)**

- Monitoring is not impaired
  - incentive for the originator to keep defaults to a minimum
  - monitoring role for rating agencies, guarantors and trustees.

- Legal and tax framework
  - facilitates asset sale and separation
  - protects both issuers and investors

**Costs Associated with Securitization**

- Interest cost of the debt
- Issuance expenses of the debt
- Also:
  - Credit enhancement and liquidity support for the assets
  - Structuring fees payable to bankers
  - Legal, accounting and tax advice fees
  - Rating agencies' fees
  - Systems modifications
  - Management time
**Costs Needed to Measure the Annual Pre-Tax Impact of Securitization**

- The interest on the securitized funding
- The annual costs of credit enhancement/liquidity lines
- Any guarantees to enhance the credit rating of any interest rate or foreign exchange swap counterparty
- Amortized front-end fees (debt issuance, credit enhancement, liquidity lines)
- Amortized transaction costs (legal, accounting, structuring, rating, etc.)
- Opportunity costs relating to any temporary cash retention in any guaranteed investment contract (GIC)
- Annual systems/accounting/rating agency costs etc.

**Sample Cost/Benefit Analysis**

<table>
<thead>
<tr>
<th></th>
<th>With securitization</th>
<th>Without securitization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio yield</td>
<td>18.50%</td>
<td>18.50%</td>
</tr>
<tr>
<td>Funding cost</td>
<td>-7.22%</td>
<td>-9.00%</td>
</tr>
<tr>
<td>Default rate</td>
<td>-5.00%</td>
<td>-5.50%</td>
</tr>
<tr>
<td>Amortized upfront issuance costs</td>
<td>-0.10%</td>
<td>-0.05%</td>
</tr>
<tr>
<td>Amortized upfront securitization costs</td>
<td>-0.20%</td>
<td></td>
</tr>
<tr>
<td>Annual costs of guarantees and credit lines</td>
<td>-0.25%</td>
<td></td>
</tr>
<tr>
<td>Annual additional costs (systems, reporting, trustee fees, etc)</td>
<td>-0.25%</td>
<td></td>
</tr>
<tr>
<td>Effect on sponsor's marginal cost of capital</td>
<td>0.00%</td>
<td></td>
</tr>
<tr>
<td>Profits</td>
<td>5.48%</td>
<td>3.95%</td>
</tr>
<tr>
<td>Net savings from securitization</td>
<td>1.53% per annum</td>
<td></td>
</tr>
</tbody>
</table>
A Corporation or Financial Institution requires additional funds to give customers financing or to finance a future revenue stream.

**Are funds freely available from banks?**
- Yes: Borrow from banks
- No: Does the firm/FI have good, self-liquidating assets?

**Does the firm/FI have good, self-liquidating assets?**
- Yes: Do the assets have a sufficiently high yield to cover servicing and other costs?
- No: Issue equity or mezzanine capital

**Do the assets have a sufficiently high yield to cover servicing and other costs?**
- Yes: Would the assets be worth more (have a cheaper all-in funding cost) if they were isolated from the company/FI?
- No: Get out of the financing business

**Would the assets be worth more (have a cheaper all-in funding cost) if they were isolated from the company/FI?**
- Yes: Securitize the assets
- No: Use assets as collateral for on-balance sheet debt