IBBM
Financing with Asset-Backed Securities

The Securitization Process

Prof. Ian Giddy
Stern School of Business
New York University
Asset-Backed Securities

- The basic idea
- What’s needed?
- The technique
- Applications
- Typical sequence
Securitization of Assets

- **Securitization is the transformation of an illiquid asset into a security.**
- For example, a group of consumer loans can be transformed into a publically-issued debt security.
- A security is tradable, and therefore more liquid than the underlying loan or receivables. Securitization of assets can lower risk, add liquidity, and improve economic efficiency.
- **Sometimes, assets are worth more off the balance sheet than on it.**
Securitization: The Basic Structure

SPONSORING COMPANY

ACCOUNTS RECEIVABLE

SALE OR ASSIGNMENT

ACCOUNTS RECEIVABLE

SPECIAL PURPOSE VEHICLE

ISSUES ASSET-BACKED CERTIFICATES
The Process

Is the company ready?

Are the assets suitable?

What pool?

What legal structure?

What credit enhancement?
Is the Company Ready for ABS?

- Does the originator currently face a **high cost of funding** assets that would be recognized as sound, cash-generating assets if taken in isolation?
- Does it have a regulatory or **capital constraint** that makes freeing up the balance sheet important?
- Does it have **data** about the assets (required by rating agencies and financial guarantors)?
- Does it have the **servicing** process and systems that can meet the more demanding standards of the asset-backed market?
- Is the originator **willing** to undertake a complex, time-consuming transaction to obtain a broader, potentially cheaper, ongoing source of funding?
Is the Company Ready for ABS?

- Corporate commitment
- Management depth
- Track record (loan program administration)
- Internal systems (origination, servicing, and collection)
- Information (on company and collateral)
- Market position
- Origination capacity
- Technology
Are the Assets Suitable?

**The Pool of Assets Should Have:**

- Volume which is sufficiently large and homogenous to facilitate statistical analysis
- A stable history of rates, defaults, delinquencies, prepayments and so forth
- Sufficient diversification--for example, geographic and socio-economic--to reduce vulnerability to economic stresses
- Basic lender’s credit quality standards that are capable of being evaluated and approved by rating agencies and specialized financial guaranty companies
- Assets must be transferable and unencumbered

*In short, the assets themselves must be sufficiently strong to support a high credit rating without the backing of the originating lender.*
Case Study: The Company
(Finance Company Limited)

- Finance company whose growth is constrained
- Has pool of automobile receivables
- Has track record
- Plans to use this as an ongoing source of financing
Key Decisions

Securitize the assets

Decisions

- Form of transfer of asset
- Form of special purpose vehicle
- Form of credit enhancement
- Form of cash flow allocation
- Form of transformation of cash flows
Case Study: Ongoing Payments

Finance Co.’s Customers

Hire-Purchase Payments

Finance Co. Ltd (Seller)

Servicing Fees

FCL 1997-A (Special Purpose Co.)

Monthly HP Payments

Monthly ABS Payments

Investors

Trustee

Trustee Responsibilities

Financial Guarantee Provider

Guarantee Responsibilities
Getting a Rating: The Risks

- Credit risks
- Liquidity risk
- Servicer performance risk
- Swap counterparty risk
- Guarantor risk
- Legal risks
- Sovereign risk
- Interest rate and currency risks
- Prepayment risks
Risk-Management Techniques in ABS

- Sponsoring Company
  - Accounts Receivable
  - Sale or Assignment
  - Special Purpose Vehicle
  - Issues Asset-Backed Certificates

- Credit Enhancement
- Sovereign Protections
- Interest Rate/Currency Hedges
- Cash Flow Reallocation
Credit Enhancement: Guarantee Method

- Finance Co.’s Customers
- Rating Agency
- FCL 1997-A (Special Purpose Co.)
- Investors
- Trustee
- Financial Guarantee Provider (if required)

- Servicing Agreement
- Top Rating
- Proceeds
- Sale of Assets
- Asset-Backed Securities
- Guarantee Agreement
- Trust Agreement
- Hire-Purchase Agreement
- Proceeds

Copyright ©2004 Ian H. Giddy
Credit Enhancement: An Alternative Approach

Finance Co. Ltd (Seller) → Proceeds
Sale of Assets

FCL 1997-A (Special Purpose Co.) → Rating Agency

Senior → Top Rating
Lower Rating
No Rating

Subordinated
More Subordinated

Financial Guarantee Provider (if required)

Guarantee Agreement

ABS Process 24
Example:
Franchise Loan Securitization

Franchisees (Borrowers)

Atherton Capital (Seller)

Mellon Mortgage (Servicer)

Loan Agreement

Loan Payments

Proceeds

Sale of Assets

Servicing Agreement

Proceeds

Asset-Backed Securities

Investors

<table>
<thead>
<tr>
<th>Class</th>
<th>Rating</th>
<th>Subordination</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1, A2, A-x</td>
<td>AAA</td>
<td>28%</td>
</tr>
<tr>
<td>B</td>
<td>AA</td>
<td>22%</td>
</tr>
<tr>
<td>C</td>
<td>A</td>
<td>16.5%</td>
</tr>
<tr>
<td>D</td>
<td>BBB</td>
<td>12%</td>
</tr>
<tr>
<td>E</td>
<td>BB</td>
<td>8.5%</td>
</tr>
<tr>
<td>F</td>
<td>B</td>
<td>5.5%</td>
</tr>
<tr>
<td>Issuer balance</td>
<td>NR</td>
<td>0%</td>
</tr>
</tbody>
</table>
Choose a Structure to Suit the Type of Assets to be Securitized

- Mortgage Securitization
- Consumer loans and credit cards
- Corporate loans
- Intangibles
- Infrastructure and Project Financing

Each class has something special that demands a different structure
# Possible Time Frame

<table>
<thead>
<tr>
<th>Months</th>
<th>Activities</th>
</tr>
</thead>
</table>
| 1      | - Determination of structure  
         |   - Information Memorandum  
         |   - Commencement of documentation |
| 2      | - Detailed cash flow analysis  
         |   - Preparation for rating process |
| 3      | - Result of cash flow analysis  
         |   - Determination of eligible receivables  
         |   - Approach rating agencies and introduction of the structure envisaged |
| 4      | - Founding of the SPV  
         |   - Initiation of stock exchange approval process (in case of a Bond issuance)  
         |   - Draft of Offering Circular (in case of a Bond issuance)  
         |   - Comments of the Rating agencies (Rating confirmation)  
         |   - Determination of funding strategy  
         |   - Publication of Offering Circular (in case of a Bond issuance)  
         |   - Marketing (in case of a Bond issuance) |
| 7      | - Completion of documentation  
         |   - Purchase of receivables and issuance of securities |

This schedule serves as an indication only and may vary from transaction to transaction.
One Bank’s Assessment

- The implementation of a transaction usually takes between two and six months, provided all necessary data and information is readily available.
- This time frame does not take into account the rating process.
The Securitization Process - 1

One Bank’s List

A private placement for a client who has done previous securitizations

- Select securitization counsel and accountants
- Consider tax, accounting and securitization objectives
- Discuss data fields required for loan data file
- Define data to be audited by accountants
- Begin drafting Private Placement Memorandum (PPM)
- Begin drafting legal documents
- Assemble preliminary pool and create initial data tape
- Consider preliminary bond structure
- Select rating agencies
- Perform integrity check on data tape (cracking the tape)

If new client, this would follow screening of corporation and loan pool for suitability

Any info used in the PPM or in the pool analysis must be audited.

If it’s a public offering, need a public Prospectus or Prospectus Supplement.

A discussion with rating agency be necessary for selection of legal structure and pool selection if it’s a new type of ABS.

Data from companies come in many different forms.
The Securitization Process - 2

One Bank’s List

- Model cash flow and bond structure
- Prepare rating agency presentation
- Select trustee/backup servicer
- Reconcile discrepancies with accountants
- Distribute rating agency presentations
- Meet with rating agencies
- Determine pending loan closings
- Select rating agencies and sign engagement letters
- Optimize loan pool and revise bond structure
- Rating agency borrower visits (if necessary)
- Rating agency due diligence (if necessary)
- Complete loan closings and finalize loan pool
- Obtain preliminary subordination levels from rating agencies

Most investment banks active in ABS have developed modelling software

Invariably, with the amount of information be supplied by the issuer via the tape, there will be mistakes/discrepancies to resolve, mostly with regard to loan data that’s been provided.

During this process, the issuer is still originating collateral going into the deal. The bank has to decide what else it want to include, and has to establish a “cut-off date”.

Which asset should not go into the pool? Its not necessarily bad collateral, but it may still hurt the overall profile of the pool.
The Securitization Process - 3
One Bank’s List

- Market transaction to sub-bond buyers (if necessary)
- Tie out collateral cash flow with accountants
- Final subordination levels from rating agencies
- Finalize bond structure based on final loan pool and sub-levels
- Tie out bond cash flows with accountants
- Finalize PPM and legal documents
- Arrange distribution by other banks
- Finalize internal marketing material
- Issuer presentation to salesforce
- Print red herring PPM and distribute to investors
- Market transaction to investors
- Price bonds and execute Bond Purchase Agreement
- Print final PPM
- CLOSE TRANSACTION

Alternative would be for originator to keep sub tranche

The collateral cash flows in aggregate are structured to pay bonds. The bonds are then sold based on the likelihood that the bonds will receive those payments at a certain period in time. Therefore, the cash flows that pay the bonds are what the investor is purchasing. The bond cash flow characteristics are presented in the prospectus to investors and if they aren’t tied out, there is a huge legal liability for the underwriter and issuer if they aren’t correct.

This is the agreement to purchase the bonds from the SPV by the investor or investment banks
Example: DBS Singa Deal
Dah Sing/Hong Kong SAR

Dah Sing Seller/Servicer → Mortgage portfolio → Hong Kong SAR Res Mort. Ltd → US$ FRN → Investors

Currency Swaps → General Re

Financial Guarantees

ASIA Ltd

CapMac
Franchise Loan Securitization

Franchisees (Borrowers)

Atherton Capital (Seller)

Mellon Mortgage (Servicer)

Loan Agreement

Loan Payments

Proceeds

Sale of Assets

Servicing Advisor

Servicing Agreement

Atherton FLF 1998-A (Special Purpose Co.)

Investors

Proceeds

Asset-Backed Securities

Class | Rating | Subordination
--- | --- | ---
A1,A2,A-x | AAA | 28%
B | AA | 22%
C | A | 16.5%
D | BBB | 12%
E | BB | 8.5%
F | B | 5.5%
Issuer balance | NR | 0%
Films (Finance for an Italian Library of Movies)
Future-Flow Financing: Offshore Purchase Agreement

YPF (Argentinian oil producer)  

Oil (under sales agreement)  

US$  

Oil Trading Co. (Cayman Is. SPV)  

Notes  

US$  

Noteholders  

US$  

Fixed debt payments  

Highly rated U.S. oil buyer  

Trust
Ian H. Giddy
Stern School of Business
New York University
44 West 4th Street, New York, NY 10012, USA

ian.giddy@nyu.edu
http://giddy.org