IBBM
Financing with Asset-Backed Securities

ABS Rating Process
and Credit Enhancement

Prof. Ian Giddy
Stern School of Business
New York University
Rating Agencies

Why bother with a rating?

- Compare equivalent credit risks across different kinds of debt: corporate, sovereign, ABS
- Compare alternatives across different ratings levels
- Obtain a relative as well as an absolute measure of credit risk
- Be reasonably sure of a market to sell the security.
Rating Agencies

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# Bond Credit Ratings

<table>
<thead>
<tr>
<th>Moody’s</th>
<th>Standard &amp; Poor’s</th>
<th>Interpretation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aaa</td>
<td>AAA</td>
<td>High-quality debt instruments</td>
</tr>
<tr>
<td>Aa</td>
<td>AA</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>A</td>
<td>Strong to adequate ability to pay principal and interest</td>
</tr>
<tr>
<td>Baa</td>
<td>BBB</td>
<td></td>
</tr>
<tr>
<td>Ba</td>
<td>BB</td>
<td>Ability to pay interest and principal speculative</td>
</tr>
<tr>
<td>B</td>
<td>B</td>
<td></td>
</tr>
<tr>
<td>Caa</td>
<td>CCC</td>
<td></td>
</tr>
<tr>
<td>Ca</td>
<td>CC</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>C</td>
<td>In default</td>
</tr>
<tr>
<td>D</td>
<td></td>
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</tr>
</tbody>
</table>
# Ratings

## Rating Scales of the U.S. Rating Agencies

<table>
<thead>
<tr>
<th>Agency</th>
<th>Investment Grade</th>
<th>Speculative Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P</td>
<td>AAA, AA+, AA, AA-</td>
<td>B, BB-</td>
</tr>
<tr>
<td>Moody's</td>
<td>Aaa, Aa1, Aa2, Aa3</td>
<td>B1, B3, Caa1, Caa2, Caa3</td>
</tr>
<tr>
<td>Fitch</td>
<td>AAA, AA+, AA, AA-</td>
<td>B, BB-</td>
</tr>
</tbody>
</table>

### Table:

<table>
<thead>
<tr>
<th>Agency</th>
<th>Rating Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P</td>
<td>AAA, AA+, AA, AA-, A+, A, BBB+, BBB, BBB-</td>
</tr>
<tr>
<td>Moody's</td>
<td>Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3</td>
</tr>
<tr>
<td>Fitch</td>
<td>AAA, AA+, AA, AA-, A+, A, BBB+, BBB, BBB-</td>
</tr>
</tbody>
</table>

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Typical Rating Report

Asset-Backed
Presale Report

Honda Auto Receivables 2004-1
Owner Trust

Expected Ratings
$347,000,000 Class A-1
  Asset-Backed Notes...................... F1+
$456,000,000 Class A-2
  Asset-Backed Notes...................... AAA
$431,000,000 Class A-3
  Asset-Backed Notes...................... AAA
$301,000,000 Class A-4
  Asset-Backed Notes...................... AAA
$47,514,648 Asset-Backed
  Certificates*............................ NR

*Retained by seller. NR – Not rated.

Summary
Fitch Ratings expects to rate the Honda Auto Receivables 2004-1
Owner Trust (the trust) notes as listed at left. The trust is also issuing
$47.5 million in certificates that are unrated and retained by the seller.
Fitch’s ratings address the likelihood that noteholders will receive full
payments of interest and principal in accordance with the terms of the
transaction documents. The ratings on the class A notes are based on
the following:

- High quality of the retail auto receivables originated and serviced
  by American Honda Finance Corporation (AHFC).
- Initial credit enhancement of 3.50% provided by a 3.00% subordinated certificate and a 0.50% nondeclining reserve account
growing to a target level of 0.75% of the initial pool balance.
- Yield supplement account (YSA) designed to compensate for
  ...
Rating Reports

ABS

Overview

Subsectors

Ratings

Issuer List

Research & Reports

Research Highlights

Special Reports

Criteria Reports

Presale Reports

Performance Reports

Index Reports

Issuance Trust Updates

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Presale Reports

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>14 Jun 2004</td>
<td>BPL Consumer S.r.l. - Series 2004</td>
</tr>
<tr>
<td>09 Jun 2004</td>
<td>GE Capital Credit Card Master Note Trust, Series 2004-1 (US ABS)</td>
</tr>
<tr>
<td>08 Jun 2004</td>
<td>Capital One Multi-asset Execution Trust, Card Series Class C (2004-9) (Europe &amp; International ABS)</td>
</tr>
<tr>
<td>02 Jun 2004</td>
<td>GM Student Loan Trust 2004-4 (US ABS)</td>
</tr>
<tr>
<td>01 Jun 2004</td>
<td>State of Connecticut Special Obligation Rate Reduction Bonds, 2004 Series A (US ABS)</td>
</tr>
<tr>
<td>27 May 2004</td>
<td>The National Collegiate Student Loan Trust 2004-1 (US ABS)</td>
</tr>
<tr>
<td>24 May 2004</td>
<td>Asset-backed European Securitization Transaction S.r.l. (Italy)</td>
</tr>
<tr>
<td>20 May 2004</td>
<td>Chase Credit Card Owner Trust, Series 2004-2 (Chase Credit Card Master Trust) (US ABS)</td>
</tr>
<tr>
<td>20 May 2004</td>
<td>C.E. Green S.r.l. (Lease ABS)</td>
</tr>
<tr>
<td>19 May 2004</td>
<td>Japanese NHK Television Fund Series One (Japan ABS)</td>
</tr>
<tr>
<td>17 May 2004</td>
<td>Condien Timeshare 2004-1, Enchaisles Funding, LLC (US ABS)</td>
</tr>
<tr>
<td>15 May 2004</td>
<td></td>
</tr>
</tbody>
</table>

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FitchRatings

Structured Finance

Asset-Backed/Europe Securitisation Transaction S.r.l.

Kicking the Tyres:
An Overview of European Auto ABS

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Summary
European auto asset-backed securities (ABS) issuance has undergone rapid growth over recent years. Total rated volume of European term issuances with auto ABS collateral has increased from EUR 450 million in 1997 to over EUR 3.5 billion by year-end 2001. Indicators point to continued growth, and issuers are experiencing the general narrowing of spreads representative of a maturing sector. To date, auto ABS has been issued across a number of European jurisdictions, including Italy, Portugal, Germany, Austria, Spain, France and the United Kingdom. Expectations are that auto ABS issuance will spread to other

---

Expected Ratings

<table>
<thead>
<tr>
<th>Issue</th>
<th>Amount</th>
<th>Maturity</th>
<th>Final Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>AAA</td>
</tr>
<tr>
<td>25 Jul 2003</td>
<td>3.0</td>
<td>8.0</td>
<td></td>
</tr>
<tr>
<td>29 Jul 2003</td>
<td>4.0</td>
<td>N/R</td>
<td></td>
</tr>
</tbody>
</table>

Analysts
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Asset-Backed European Securitisation Transaction S.r.l.

Fitch Ratings has assigned expected ratings to the notes to be issued by A-BEST, a limited liability company incorporated in Italy, as indicated at left.

This EUR 726 million transaction is the third ABS phase of a securitisation programme that Fiat SAVIA S.p.A. (SAVIA) set up for securitising part of its auto loans portfolio. The programme has been executed in several stages.

- In mid-June 2003, SAVIA sold a pool of auto loans to Nixa S.r.l. (“Nixa”), a Law 130 special purpose vehicle, which funded the purchase by issuing asset-backed notes under a

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ABS Rating Process 7
Spread Analysis

Relative Value

Euribor-Spread (3-5 years)

Asset class

CLO (A)
MBS (A)
ABS (A)
Corporates (A)
CLO (AAA)
MBS (AAA)
ABS (AAA)
Corporates (AA)
Corporates (AAA)
Pfandbriefe Jumbos
## Spread Analysis

### Relative Value

<table>
<thead>
<tr>
<th>Rating</th>
<th>Euribor Mid-Spreads</th>
<th>R.W.</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>-3/+3</td>
<td>10%</td>
</tr>
<tr>
<td>AAA</td>
<td>+2/+7</td>
<td>10%</td>
</tr>
<tr>
<td>AAA</td>
<td>flat/+10*</td>
<td>100%</td>
</tr>
<tr>
<td>AA</td>
<td>+25/+35*</td>
<td>100%</td>
</tr>
<tr>
<td>A</td>
<td>+45/+55*</td>
<td>100%</td>
</tr>
<tr>
<td>AAA</td>
<td>+25/+28</td>
<td>100%</td>
</tr>
<tr>
<td>A</td>
<td>+65/+75</td>
<td>100%</td>
</tr>
<tr>
<td>AAA</td>
<td>+28/+32</td>
<td>100%</td>
</tr>
<tr>
<td>A</td>
<td>+50/+70</td>
<td>100%</td>
</tr>
<tr>
<td>AAA</td>
<td>+26/+36</td>
<td>100%</td>
</tr>
<tr>
<td>A</td>
<td>+65/+85</td>
<td>100%</td>
</tr>
</tbody>
</table>

* exceptions even wider or tighter

### Recent issues

<table>
<thead>
<tr>
<th>Rating</th>
<th>Euribor Mid-Spreads</th>
<th>R.W.</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA(5y), A(7y)</td>
<td>+25/+65</td>
<td>100%</td>
</tr>
<tr>
<td>AAA(5.1y), Aa3(8y)</td>
<td>+32/+55</td>
<td>100%</td>
</tr>
<tr>
<td>AAA(5y), A(5y)</td>
<td>+40/+100</td>
<td>100%</td>
</tr>
<tr>
<td>AAA(4.4y), A(7y)</td>
<td>+25.5/+75</td>
<td>100%</td>
</tr>
<tr>
<td>AAA(5.6y), A(10y)</td>
<td>+26/+75</td>
<td>50%</td>
</tr>
<tr>
<td>AAA(3.8y), A2(3.8y)</td>
<td>+26/+65</td>
<td>100%</td>
</tr>
<tr>
<td>AAA(5y), A(5y)</td>
<td>+26/+75</td>
<td>100%</td>
</tr>
</tbody>
</table>
# Default Matrix

<table>
<thead>
<tr>
<th>Collateral Rating</th>
<th>Fitch IBCA Default Curve**</th>
<th>'BB'</th>
<th>'BBB'</th>
<th>'A'</th>
<th>'AA'</th>
<th>'AAA'</th>
</tr>
</thead>
<tbody>
<tr>
<td>'AAA'</td>
<td>1.0</td>
<td>0.0</td>
<td>0.5</td>
<td>0.8</td>
<td>1.0</td>
<td>1.3</td>
</tr>
<tr>
<td>'AA'</td>
<td>1.2</td>
<td>0.6</td>
<td>0.9</td>
<td>1.2</td>
<td>1.4</td>
<td>2.3</td>
</tr>
<tr>
<td>'A'</td>
<td>1.3</td>
<td>1.0</td>
<td>1.3</td>
<td>1.6</td>
<td>4.3</td>
<td>5.0</td>
</tr>
<tr>
<td>'BBB'</td>
<td>4.0</td>
<td>4.0</td>
<td>5.0</td>
<td>10.0</td>
<td>12.0</td>
<td>14.0</td>
</tr>
<tr>
<td>'BB+'</td>
<td>12.7</td>
<td>16.1</td>
<td>18.4</td>
<td>25.3</td>
<td>34.8</td>
<td>47.5</td>
</tr>
<tr>
<td>'BB'</td>
<td>16.0</td>
<td>20.0</td>
<td>21.6</td>
<td>27.9</td>
<td>39.9</td>
<td>54.3</td>
</tr>
<tr>
<td>'BB-'</td>
<td>20.6</td>
<td>24.3</td>
<td>26.8</td>
<td>34.0</td>
<td>46.4</td>
<td>59.7</td>
</tr>
<tr>
<td>'B+'</td>
<td>25.2</td>
<td>29.0</td>
<td>31.6</td>
<td>39.1</td>
<td>50.5</td>
<td>64.1</td>
</tr>
<tr>
<td>'B'</td>
<td>29.9</td>
<td>33.2</td>
<td>35.8</td>
<td>43.3</td>
<td>52.3</td>
<td>67.2</td>
</tr>
<tr>
<td>'B–'</td>
<td>34.5</td>
<td>36.9</td>
<td>39.7</td>
<td>48.3</td>
<td>57.0</td>
<td>70.8</td>
</tr>
</tbody>
</table>

*Midpoint stressed default rates for corporate bonds. Loan default rates would be slightly lower. **Cumulative 10-year default probability of a corporate bond at an initial rating level. †For example, credit enhancement levels for an 'AA' note rating must cover 12% default stress on a portfolio with an average rating of 'BBB'.

Source: Fitch, “Bank CLOs”
Rating Reports: Who Pays for Them?

- General reports on a sector, like CLOs
- Pre-sale report on an individual CLO, once risks have been evaluated but final terms and credit enhancement have not yet been finanized
- Final deal report
- Periodic updates
ABS: Factors Agencies Examine

- Asset portfolio analysis
- Legal structure of the transaction
- Quality of the originator/servicer
- The trustee
- The cash flow structure
- The counterparties
Rating Agencies: Business Analysis

- Organization and management structure
- Financial performance
- Business strategy and planning processes
- Controls and procedures
- Asset origination and credit assessment procedures
- Quality of its loan documentation
- Credit administration and debt recovery procedures
Rating Process

Issuer/Banker Requests rating

List information requirements
Due diligence &
Meeting with management

Pool credit analysis
Legal analysis
Stress testing

Credit enhancement negotiation

Deal documentation

Rating committee
Presale report
Final report

Surveillance

“Rating CLOs” (Fitch)
on Workshop Website
giddy.org/abs-hypo.htm
Credit Enhancement

- Senior/Sub or overcollateralization
- Reserve and liquidity accounts and lines
- Excess cash flow
- Third-party guarantees
### The Result: Bond Credit Ratings

<table>
<thead>
<tr>
<th>Moody’s</th>
<th>Standard &amp; Poor’s</th>
<th>Interpretation</th>
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<tr>
<td>Baa</td>
<td>BBB</td>
<td></td>
</tr>
<tr>
<td>Ba</td>
<td>BB</td>
<td>Ability to pay interest and principal speculative</td>
</tr>
<tr>
<td>B</td>
<td>B</td>
<td></td>
</tr>
<tr>
<td>Caa</td>
<td>CCC</td>
<td></td>
</tr>
<tr>
<td>Ca</td>
<td>CC</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>C</td>
<td>In default</td>
</tr>
<tr>
<td></td>
<td>D</td>
<td></td>
</tr>
</tbody>
</table>
Rating ABS: S&P vs Moody’s

- Standard & Poor's method traditionally has been asset-based, related to the liquidation value of the assets in the pool. Their ratings logically follow from a default frequency concept.

- Moody's analysis, the basis for ABS ratings is the average reduction of yield on diversified portfolios of similarly rated securities over the life of the portfolio.
Alternative Models

- McKinsey Model highlights the role of the credit cycle in risk
- CreditRisk Plus (CSFP) uses actual default rates and their volatilities
- Creditmetrics: based on transition matrix and portfolio theory
- KMV: Expected Default Frequency based on stock price volatility
# Transition Matrix

<table>
<thead>
<tr>
<th>Initial Rating</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
<th>CCC</th>
<th>Default</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>90.81</td>
<td>8.33</td>
<td>0.68</td>
<td>0.06</td>
<td>0.12</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>AA</td>
<td>0.70</td>
<td>90.65</td>
<td>7.79</td>
<td>0.64</td>
<td>0.06</td>
<td>0.14</td>
<td>0.02</td>
<td>0</td>
</tr>
<tr>
<td>A</td>
<td>0.09</td>
<td>2.27</td>
<td>91.05</td>
<td>5.52</td>
<td>0.74</td>
<td>0.26</td>
<td>0.01</td>
<td>0.06</td>
</tr>
<tr>
<td>BBB</td>
<td>0.02</td>
<td>0.33</td>
<td>5.95</td>
<td>86.93</td>
<td>5.30</td>
<td>1.17</td>
<td>0.12</td>
<td>0.18</td>
</tr>
<tr>
<td>BB</td>
<td>0.03</td>
<td>0.14</td>
<td>0.67</td>
<td>7.73</td>
<td>80.53</td>
<td>8.84</td>
<td>1.00</td>
<td>1.06</td>
</tr>
<tr>
<td>B</td>
<td>0</td>
<td>0.11</td>
<td>0.24</td>
<td>0.43</td>
<td>6.48</td>
<td>83.46</td>
<td>4.07</td>
<td>5.20</td>
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<tr>
<td>CCC</td>
<td>0.22</td>
<td>0</td>
<td>0.22</td>
<td>1.30</td>
<td>2.38</td>
<td>11.24</td>
<td>64.86</td>
<td>19.79</td>
</tr>
</tbody>
</table>

Source: Standard & Poor's CreditWeek (15 April 96)
Credit Risk versus Market Risk

Typical market returns

Typical credit returns

Losses

0

Gains

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ABS Rating Process   20
# Stress Testing

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Hypothetical Deal</th>
<th>Stress Test One</th>
<th>Stress Test Two</th>
<th>Stress Test Three</th>
<th>Stress Test Four</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chargeoffs</td>
<td>Remain stable at 5%</td>
<td>Increase to 20%</td>
<td>Increase to 20%</td>
<td>Increase to 20%</td>
<td>Increase to 20%</td>
</tr>
<tr>
<td>Payment Rate</td>
<td>Remains stable at 15%</td>
<td>Remains stable at 15%</td>
<td>Decreases to 7%</td>
<td>Decreases to 7%</td>
<td>Decreases to 7%</td>
</tr>
<tr>
<td>Yield</td>
<td>Remains stable at 18%</td>
<td>Remains stable at 18%</td>
<td>Remains stable at 18%</td>
<td>Decreases to 10%</td>
<td>Decreases to 10%</td>
</tr>
<tr>
<td>Pool Size</td>
<td>Remains stable</td>
<td>Remains stable</td>
<td>Remains stable</td>
<td>Remains stable</td>
<td>Decreases by 70%</td>
</tr>
<tr>
<td>Result</td>
<td>Deal ends as planned after 9 months.</td>
<td>Deal goes into early-amortization and investors are repaid on time.</td>
<td>Deal does not mature on time (takes extra 3 mo.), although investors are repaid.</td>
<td>Deal does not mature on time (takes extra 2 mo.), although investors repaid.</td>
<td>Deal fails. No one willing to buy assets. Investors are not fully repaid.</td>
</tr>
<tr>
<td>Investors Repaid?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

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## Stress Testing & Credit Enhancement

<table>
<thead>
<tr>
<th>Collateral</th>
<th>Default probability 10yr</th>
<th>Note rating</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>BBB</td>
</tr>
<tr>
<td>AAA</td>
<td>1%</td>
<td>0.5</td>
</tr>
<tr>
<td>BBB</td>
<td>4%</td>
<td>5.0</td>
</tr>
<tr>
<td>B-</td>
<td>34.5%</td>
<td>39.7</td>
</tr>
</tbody>
</table>

Source: FitchIBCA Bank CLOs
KMV: Owning a Bond Is Like Writing a Covered Call Option

**Assets**
Value of future cash flows

**Liabilities**

**Debt**
- Contractual int. & principal
- No upside
- Senior claims
- Control via restrictions

**Equity**
- Residual payments
- Upside and downside
- Residual claims
- Voting control rights
KMV: Owning a Bond Is Like Writing a Covered Call Option
Typical Rating Analysis

Pre-securitization risk reduction
- Originator’s credit underwriting standards
- Screening of assets to be included in the portfolio
- Diversification of the portfolio

Legal structure based credit risk reduction
- Legal insulation from originator default
- Legal insulation from servicer default

Credit quality of deal participants
- Originator/Seller/Servicer
- Trustee, swap counterparties
- Guarantors

Integrity of cash flow structure
- Cash flow sufficiency and mismatches
- Safeguards and agreements such as swaps or caps

Credit enhancement
- “Internal” credit enhancement
- “Third party” credit enhancement

Rating
- Direct recourse
- Senior/subordination or overcollateralization
- Reserve or spread accounts
- Cash collateralized accounts
- Financial guarantees
Credit Enhancement

- Overcollateralization
- Senior/Sub or
- Reserve and liquidity accounts and lines
- Excess cash flow
- Third-party guarantees
Credit Enhancement

- LOCs and puts
- Over-collaterization
- Senior/subordinate structure
- Recourse to originator
- Cash collateral
- “Wrap” guarantee from monoline
- “First-Loss” Protection
- “Second-Loss” Protection
Over-Collateralization Method

SPECIAL-PURPOSE VEHICLE

COLLATERAL POOL

OVER-COLLATERAL

SENIOR ASSET-BACKED SECURITIES

“EQUITY” ABS (owned by seller)
## Example of Senior/Sub Structure

<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>
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<tr>
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<td>5.5%</td>
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<tr>
<td>Issuer balance</td>
<td>NR</td>
<td>0%</td>
</tr>
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</table>
Use of a Cash Reserve Account

1. The payments are made to the bank, as before the sale.
2. The bank passes the payments on to the trustee.
3. The trustee pays investors their interest.
4. The trustee pays the bank a fee for servicing the loan.
5. The difference between the portfolio yield, the investor interest, and the servicing fee is paid to the reserve account.
6. The reserve account is used to reimburse the letter of credit bank for draws occasioned by defaults by borrowers on the loans.
7. When the reserve account reaches its cap, excess funds flow back to the selling bank.
Role of Financial Guarantees

- Why use guarantees?
- The guarantors: banks, pool insurers, financial guarantors
- What do they guarantee?
- Who guarantees the guarantors?
- Getting a guarantee
- Cost of a guarantee
- Ongoing monitoring by the guarantee companies
CLO Rating Process (Fitch)

- Information request
- Initial review
  - Bank’s internal credit standards, history
  - Credit scoring correlation
  - Chargeoffs and nonaccruals
- Due diligence
- Legal
- SPV
- Participations vs assignments vs CLNs
- Determining credit enhancement
Case Study: Atherton Franchisee Loan Funding

- What are the credit risks of the underlying franchise loans?
- What other risks should a rating agency consider?
- What is Fitch’s method for rating franchise loans?
- How are investors protected?

Group work
Asset-Backed Securities

Getting a Rating:
Franchise Loan Securitization

Prof. Ian Giddy
Stern School of Business
New York University
Case Study: Atherton Franchisee Loan Funding

- What are the credit risks of the underlying franchise loans?
- What other risks should a rating agency consider?
- What is Fitch’s method for rating franchise loans?
- How are investors protected?
Atherton Structure

Franchisees (Borrowers) -> Loan Agreement

Atherton Capital (Seller) -> Loan Payments

Mellon Mortgage (Servicer) -> Servicing Agreement

Atherton FLF 1998-A (Special Purpose Co.)
- Proceeds
- Sale of Assets

Investors
- Proceeds
- Asset-Backed Securities
Franchise Loan Securitization: Credit Risk Factors

- Default
  - Fixed-Charge Coverage Ratio (borrower)
  - Concept strength tiering
  - Units under management and operator experience
  - Unit seasoning

- Recovery
  - Collateral type
  - Loan-to-value ratio
  - FCCR (unit)
Fixed Charges

$10,000
$20,000
$60,000

Profits
Variable costs
Fixed charges

Fixed charge coverage ratio
= Revenues/Fixed charges
= 90,000/60,000
= 1.50
Example: Atherton

- Pool FCCR is “better than average”
- Weighted-average FCCR is 1.56x
- Weighted-average LTV is 66.5%
The Fitch IBCA model uses key factors to determine conditional expected default frequency and conditional expected recovery value for each loan in the pool.
Other Factors in Rating

- Transaction legal structure
- Originator’s credit underwriting standards
- Servicer capabilities
- Environmental
- Legal issues
Result:

- How much credit enhancement is needed for each rating?
  (Based on LDRM and qualitative factors)
**Example: Atherton**

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