Review

Prof. Ian Giddy
Stern School of Business
New York University
Corporate Financing Choices

- Do financing choices matter?
- Debt or equity?
- What kind of debt?

Certain kinds of *market imperfections* allow corporations to reduce costs by improving the financing mix.
Asset-Backed Securities: Summary

- Asset-backed securities can create value for investors and issuers if:
  - The assets are for some reason worth more off the balance sheet than on
  - The right legal framework is in place
  - The costs do not exceed the benefits

- Sometimes they do not work because you cannot make money by cutting up a dog
Asset-Backed Securities

- Why securitization works
- Mortgages and mortgage-backed securities
  - The technique: creating MBS
  - The option element
- Asset securitization
  - Issuer view
  - Investor view
  - The technique
Structure of the US MBS Market

Mortgage Loan
Bank (mortgage originator) makes a whole loan
Ancillary: brokers, servicers, insurers

Mortgage Pass-Through
FNMA or GMAC (conduit) pools
mortgage loans with similar characteristics

CMO or REMIC
Takes a mortgage pool and makes the
cash flows more predictable by assigning
priority of claims to the cash flows

MBS Portfolio
Institutional investor evaluates risk/return
behavior of mortgage-backed securities through
option-adjusted price and spread analysis

Mortgage Strips
Interest-Only and Principal-Only
Convexity of Callables

Mortgage-backed securities and other callable bonds may have negative convexity which cushions a bond’s price rise and accelerates its fall!
The Technique Illustrated

SPONSORING COMPANY

ACCOUNTS RECEIVABLE

SALE OR ASSIGNMENT

ACCOUNTS RECEIVABLE

SPECIAL PURPOSE VEHICLE

ISSUES ASSET-BACKED CERTIFICATES
True ABS: The Rationale

Asset securitization makes sense when the assets are worth more outside the company than within.

But what makes them worth more outside?
Synthetic ABS

GERMAN BANK (Originator)

REFERENCE POOL OF LOANS
(Stay on Balance Sheet)

PROTECTION against
POOL DEFAULTS

EURIBOR plus
"PREMIUM"

TOP QUALITY INVESTMENTS

SPECIAL PURPOSE VEHICLE

ISSUES ASSET-BACKED CERTIFICATES
Critique of Ratings

- Agencies compete to get deals
- Use of formulas manipulated by investment banks
- Delayed downgrades?
- Drift to quality – comparison with corporates
- Waterfall upgrades
- Things fall apart
Issuer economics

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Excess Servicing Fees
Investor economics

- Rates
- Ratings
- Risk
- Liquidity
- Spread analysis
Splitting the Cash Flows

- Paydown sequence: Chrysler
- Senior/Subordinated: Res. Trust Co.
Paydown Structure

- Seller interest
- June 1999 (princ. Commencement)
- Clean-up call

Timeline:
- Nov 1994
- Jan 2000 (exp. Final)
- Nov 2001 (Final)
Focus on Asset Classes

- Mortgages
- Credit card ABS
- Auto receivables ABS
- Leases & supply contracts
Hong Kong/Chase
Project Financing

- Stand-alone, non-recourse "production payment financing"
- Structure
- Participants
- Funding sources
- Risks
ABS or Corporate Debt?

**KEY ISSUES:**
- **WHAT ARE THE ASSETS BEING TRANSFERRED?**
- **ARE THEY IDENTIFIABLE FINANCIAL CLAIMS ON SPECIFIC BORROWERS?**
- **IS THE POOL AMENABLE TO STATISTICAL AND HISTORICAL ANALYSIS?**
- **IS ITS VALUE DEPENDENT ON THE SUCCESS OF THE SPONSOR’S BUSINESS?**
The Final Analysis

- The Deal – what kind?
- The pool
- The business and the cash flow economics
- The structure
- The parties involved – motivation and quality
Focus on Asia

- Steps to implementation in Malaysia
- Indonesia’s experience
- Hong Kong deals
- Singapore, bank-driven
- Korea’s rapid growth
- Role of rating agencies
- Role of insurers
Pricing Credit Risk for the Capital Market: Opportunities for Asian Banks

What is the “capital markets” approach to management of bank credit risk?

- Better pricing of risky debt
- Securitization and liquidity creation
- Separation of lending from management of turnaround, equity-like assets
From Credit to Equity

- Lessons from vultures
- Management of equity risk
- VC approach
- Equity distribution
- Role of research
- Role of sales
- Corp governance and minority shareholder rights
ABSresearch.com

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