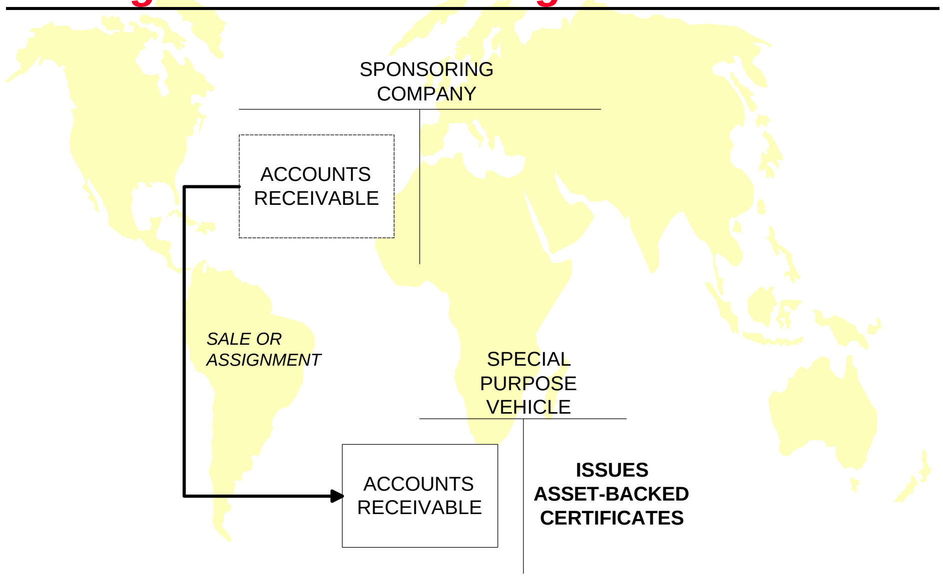
Asset-Backed Securities

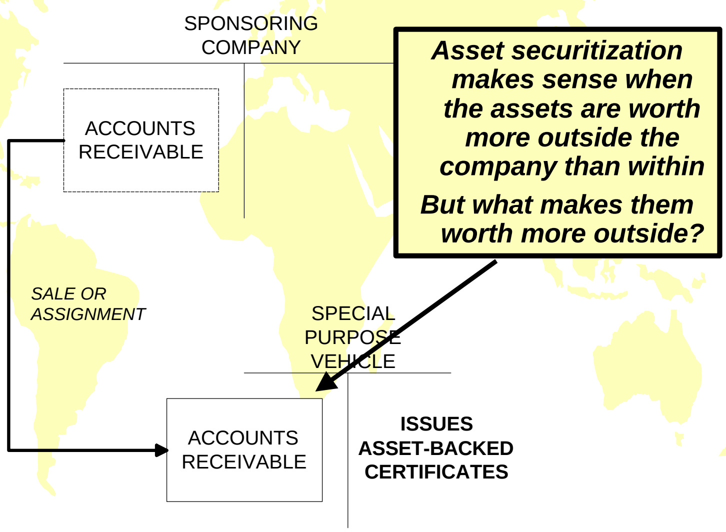
Asset Securitization: Cost-Benefit Analysis

Prof. Ian Giddy
Stern School of Business
New York University

Separation of Two Businesses: Origination and Lending



Separation of Two Businesses: Origination and Lending



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 Benefits to Investors

- Investors can achieve
  - Superior return.
  - Liquidity.
  - Diversification.
  - Event risk reduction.
- But
  - ABS are more complex – legal, collateral, etc
  - Some risks remain, such as prepayment risk
  - What can cause rating change?
  - What determines ABS spreads?

Spread Analysis

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 (eg 0.5% of the consumer finance market)

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

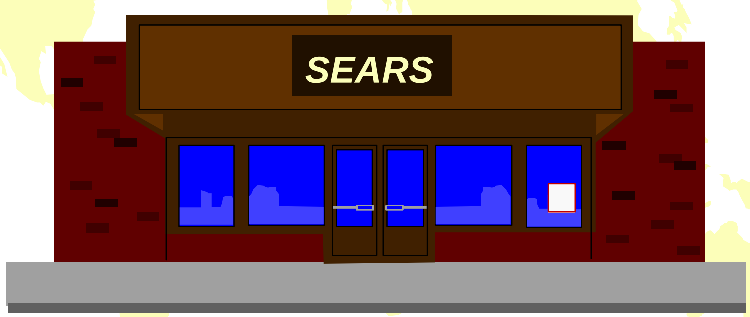
Securitization Cost-Benefit Analysis (for a regulated financial institution)			Gain/cost ($ millions)
Funding cost savings	☐	Two-year bank notes vs pass-though rate	1.1
Upfront costs	☐ ☐	Underwriting SEC filing, legal fees, etc	(2.6)
Ongoing costs	☐	Letter-of-credit fee	(0.5)
Capital charge	☐	Cost of capital at 25% (15% after tax)	7.7
Net benefit			***5.7***

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?



Why Did Chrysler Use ABS in 1992?

- Downgraded to B+ in early 1992
- Lost access to its normal funding sources
- Needed to continue to fund its car loans
- Only way to do this was to securitize the loans
- “Firms that securitize tend to have considerably weaker credit quality than other firms.”

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

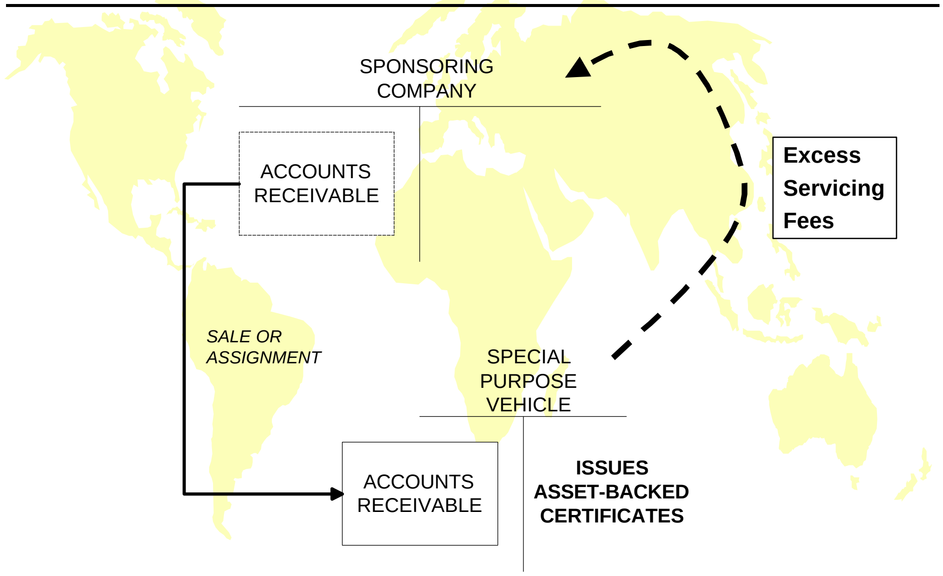
Costs Associated with Securitization

- Interest cost of the debt
- Issuance expenses of the debt
- Also:
  - Credit enchancement 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.

The Key Lies in the Excess Servicing Fees



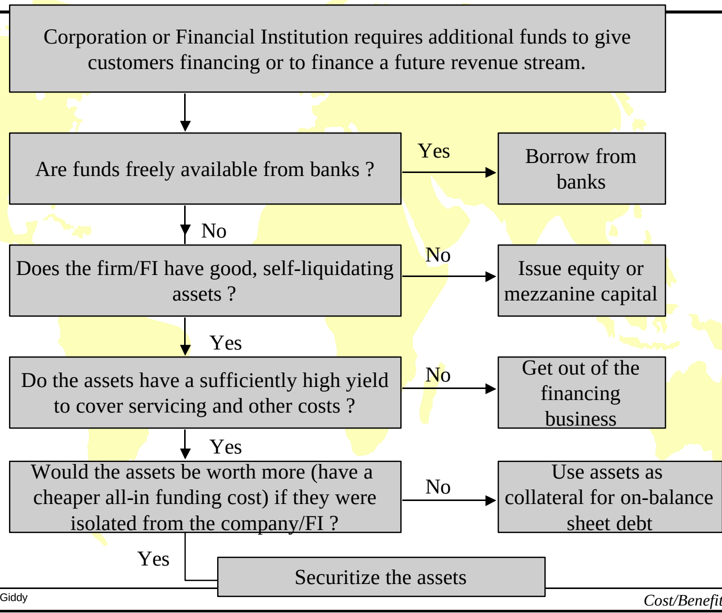
Sample Cost/Benefit Analysis

	With securitization	Without securitization
Portfolio yield	18.50%	18.50%
Funding cost	-7.22%	-9.00%
Default rate	-5.00%	-5.50%
Amortized upfront issuance costs	-0.10%	-0.05%
Amortized upfront securitization costs	-0.20%	
Annual costs of guarantees and credit lines	-0.25%	
Annual additional costs (systems, reporting, trustee fees, etc)	-0.25%	
Effect on sponsor's marginal cost of capital	0.00%	
Profits	5.48%	3.95%
Net savings from securitization	1.53%	per annum

Ford Credit Auto Owner Trust

- What are the economic benefits and costs to Ford in this ABS deal?
- What do the underlying assets earn?
- What rates do the securities pay?
- Other costs?
- Who gets the excess spread?

The Decision Process



globalsecuritization.com

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

Tel 212-998-0332
ian.giddy@nyu.edu
http://giddy.org