Asset-Backed Securities

- The basic economics
- Issuer benefits & costs
- Investor benefits and risks
- The technique

Separation of Two Businesses: Origination and Lending

- Asset securitization makes sense when the assets are worth more outside the company than within. But what makes them worth more outside?

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.
  - Overcome constraints
- But
  - ABS are more complex
  - Some risks remain, such as prepayment risk

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)

The Chicken Theory

$7.99

The Economics of Asset Securitization

How should firms finance themselves? Two theories:

- A company's value comes from its real business: you can't increase its value by rearranging its liabilities. “You can't make money by cutting up the chicken and selling the parts.”
- You can make money by cutting up a chicken:
  - Investors pay extra for securities tailored to their needs and constraints
  - Taxes (and subsidies)
  - Information asymmetries
  - Agency costs

But how does this apply to asset securitization?

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</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</td>
</tr>
<tr>
<td></td>
<td>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>
</tbody>
</table>

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

- Market imperfections are present
  - Investor information about the originators’ operations is costly
  - Agency costs are high, or
  - Issuers are constrained by capital or other regulations, or where
  - Investors’ choices are constrained
  - Government provides explicit or implicit backing for the issuer’s debt.
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

Originator Suitability Criteria

- 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?

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>Gains or savings from securitization</th>
<th>Amount, % per annum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings on borrowing rate paid</td>
<td>2.5</td>
</tr>
<tr>
<td>Savings on capital cost</td>
<td>1.3</td>
</tr>
<tr>
<td>Servicing fees</td>
<td>1.0</td>
</tr>
<tr>
<td>Residual amounts returned upon retirement of ABS</td>
<td>1.1</td>
</tr>
<tr>
<td>Total gains</td>
<td>11.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Additional costs from securitization</th>
<th>Amount, % per annum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foregone revenue from the assets</td>
<td>0.8</td>
</tr>
<tr>
<td>Higher expenses on debt</td>
<td>0.7</td>
</tr>
<tr>
<td>Servicing fees</td>
<td>0.5</td>
</tr>
<tr>
<td>Amortized front-end fees (credit enhancement, liquidity lines, guarantee)</td>
<td>0.3</td>
</tr>
<tr>
<td>Amortized transaction costs (legal, accounting, structuring, rating, etc.)</td>
<td>0.2</td>
</tr>
<tr>
<td>Management time</td>
<td>0.1</td>
</tr>
<tr>
<td>Total costs</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Net savings from securitization | 9

The Decision Process

1. Corporation or financial institution requires additional funds to give customers financing or to finance a future revenue stream.
2. Are funds freely available from banks?
   - Yes → Borrow from banks
   - No → Proceed to 3
3. Does the firm/FI have good, self-liquidating assets?
   - Yes → Issue equity or mezzanine capital
   - No → Proceed to 4
4. Do the assets have a sufficiently high yield to cover servicing and other costs?
   - Yes → Proceed to 9
   - No → Refinance the financing business
5. Would the assets be worth more than a cheaper all-in funding cost if they were isolated from the company/FI?
   - Yes → Securitize the assets
   - No → Refinance the financing business

Note: This process may involve additional steps and considerations, such as the evaluation of collateral and the overall financial strategy of the company/FI.
Costs and Benefits of 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

Sears Credit Account Master Trust

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

See Excel Spreadsheet abs_cost-benefit.xls

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