Asset-Backed Securities: Managing the Credit Risks

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Identifying 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

Managing the Risks

- Identifying the risks
- The role of rating agencies
- Managing the credit risks
- Managing the sovereign risks

Rating Agencies

Why a rating?
- compare alternatives across different ratings categories;
- obtain a relative as well as an absolute measure of credit risk
- be reasonably sure of a market to sell the security.
Managing the Risks: Role of the Rating Agencies

- Asset portfolio analysis
- Legal structure of the transaction
- Credit quality of the originator
- The trustee
- The cash flow structure
- The counterparties

Key Factors Agencies Examine

- The quality of the pool of assets, evaluated as a portfolio
- The credit quality of all the parties to the deal.
- Operational support for servicing, transfer, recording, follow-up, etc.
- Credit enhancement
- Legal structure
- Sovereign risks
- Market price risks
- Payment timing risks

Aspects of the Business Reviewed by Rating Agencies and the Credit Enhancer

- 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

Role of Originator’s Review Systems

- Produce historical information on the assets to be securitized
- Identify and segregate the securitizable assets and track their cash flows
- Report on the performance of the securitized assets

Rating Agency Requirements - 1

Legal Structure

- Information on parties involved in the ABS issuance, namely, the originator(s), servicer, merchant bank, lawyers, accountants, trustees, credit enhancer, liquidity banks.
- Proposed legal structure and documentation e.g., type of assets to be securitized, senior/subordination features, pass-through/spay-throughs, any recourse provisions, corporation/trust, over-collateralisations, other risks and claims structure, etc.
- Legal and accounting opinions (and subsequently regulator’s opinion) on the characterization of the transferred assets i.e., a "true sale" or "pledge". The legal opinion should also extend to opinions on the possible impact of the issuer's bankruptcy on the securitized assets, liability to stamp duty and sales tax.
- Tax opinions on how to SPV would be taxed and whether investors’ investment in the ABS represent debt or equity to the SPV.

Rating Agency Requirements - 2

Credit Risk

- 10-year industry statistics/analysis on the assets to be securitized e.g., yield statistics of assets, non-performing loans, ageing/delinquencies, customer demographics and repossession rate.
- Summarized 10-year historical records/statistics on the originator's HP portfolio, focusing on portfolio performance and characteristics including the following:
  - Growth
  - Yield
  - Underwriting standards and loan terms/maturity
  - Recourse provisions to motor-vehicle dealers
  - Ageing/delinquencies rate
  - Collection and recovery procedures (including repossession rate)
  - Customer profile/demographics
  - New versus used equipment
  - Prepayment history
Rating Agency Requirements - 3

Credit Risk (continued)
- Information on the intended pool selection process including the following:
  - Maturity period
  - Seasoning
  - Loan to value of assets
  - Whether insured, types of policy, insure amount
  - Delinquency factor
  - Any previous extension and rewrites
  - Interest rate

Cash Flow Structure
- Cash flow mechanics/control
- Timing of receipts and payments
- Liquidity support

Managing the Credit Risks

- The assets are chosen and the legal structure designed to get an investment grade rating.
  - Internal credit improvement, e.g., the SPV's debt is "overcollateralized", or the parent agrees to replenish the asset pool if its value falls, or the SPV has a subordinated debt tranche
  - External credit improvement, e.g., a guarantee or letter of credit is purchased from a third party

Asset-Backed Securities: Managing the Risks

- Cash collateral
- LOCs and puts
- Over-collateralization
- Senior/subordinated structure
- Recourse to originator

“First-Loss” Protection

“Second-Loss” Protection

Over-Collateralization/ Subordinated Tranche

Senior/Subordinated Structure with Cash Reserve Account

Use of a Cash Reserve Account
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.

Managing the Sovereign Risks

- Secure sovereign guarantees
- Employ offshore jurisdictions
- Securitize foreign-source assets or cash flows
- Obtain a guarantee from a foreign financial institution
- Obtain a guarantee from a foreign financial institution

Managing the Risks: Offshore Purchase Agreement

Asset-Backed Securities: Role of Financial Guarantees

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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

The Financial Guarantors

- Banks
- General property/casualty companies providing "pool" insurance
- Specialized financial guaranty companies

What do they Guarantee?

- Full principal and interest guarantee
- Partial guarantees

Who Guarantees the Guarantors?

- Regulatory controls
- Rating the guarantors
- Role of reinsurance

Practical Aspects of Financial Guarantees

- Getting a guarantee
- Cost of a guarantee
- Ongoing monitoring by the guarantee companies

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