## Asset-Backed Securities: Overview

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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

Focus on Asset Classes

- Mortgages
- Credit card ABS
- Auto receivables ABS
- Leases & supply contracts
- Asset-backed commercial paper
- Intangible expected revenues
- Future-flow ABS
Legal, Tax & Accounting

Sponsor/Parent

Trust

Pass-Through Securities

Corporation

Pay-Through Securities

Consolidation into parent could cause problems

Credit Risks & 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
Cost-Benefit Analysis: The Decision Process

Corporation or Financial Institution requires additional funds to give customers financing or to finance a future revenue stream.

- Are funds freely available from banks? Yes → Borrow from banks
  No → Does the firm/FI have good, self-liquidating assets?

- Does the firm/FI have good, self-liquidating assets? Yes → Issue equity or mezzanine capital
  No → Get out of the financing business

- Do the assets have a sufficiently high yield to cover servicing and other costs? Yes → Use assets as collateral for on-balance sheet debt
  No → Would the assets be worth more (have a cheaper all-in funding cost) if they were isolated from the company/FI?

- Would the assets be worth more if they were isolated from the company/FI? Yes → Securitize the assets
  No → No

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

- Mortgage Strips
  Interest-Only and Principal-Only

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

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**Non-Mortgage ABS: The Technique Illustrated**
Alternative Ways of Structuring Asset Securitization

- Collateralized bonds
- Pass-through securities
- Pay-through securities

Splitting the Cash Flows

- Paydown sequence: Chrysler
- Senior/Subordinated: Res. Trust Co.
Managing Cash Flow Risks with Swaps

- Fixed GBP 12.73%
- Floating USD Libor s.a. +0.75%

Hong Kong/Chase
Project Financing

- Stand-alone, non-recourse "production payment financing"
- Structure
- Participants
- Funding sources
- Risks