Asset Securitization: Cost-Benefit Analysis

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Separation of Two Businesses: Origination and Lending
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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.
- But
  - ABS are more complex – legal, collateral, etc
  - Some risks remain, such as prepayment risk
  - What can cause rating change?
  - What determines ABS spreads?

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

<table>
<thead>
<tr>
<th>Securitization Cost-Benefit Analysis</th>
<th>Gain/cost ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funding cost savings</td>
<td>Two-year bank notes vs pass-through rate 1.1</td>
</tr>
<tr>
<td>Upfront costs</td>
<td>Underwriting (2.6)</td>
</tr>
<tr>
<td>Ongoing costs</td>
<td>SEC filing, legal fees, etc (0.5)</td>
</tr>
<tr>
<td>Capital charge</td>
<td>Cost of capital at 25% (15% after tax) 7.7</td>
</tr>
<tr>
<td><strong>Net benefit</strong></td>
<td>5.7</td>
</tr>
</tbody>
</table>
**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.

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**Sears: Asset-Backed Financing?**

[Image of a Sears store]
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 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.

**The Key Lies in the Excess Servicing Fees**

[Diagram showing the flow from Sponsoring Company to Accounts Receivable, Special Purpose Vehicle, Accounts Receivable, Sale or Assignment, and Issues Asset-Backed Certificates with Excess Servicing Fees indicated.]
Sample Cost/Benefit Analysis

<table>
<thead>
<tr>
<th></th>
<th>With securitization</th>
<th>Without securitization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio yield</td>
<td>18.50%</td>
<td>18.50%</td>
</tr>
<tr>
<td>Funding cost</td>
<td>-7.22%</td>
<td>-9.00%</td>
</tr>
<tr>
<td>Default rate</td>
<td>-5.00%</td>
<td>-5.50%</td>
</tr>
<tr>
<td>Amortized upfront issuance costs</td>
<td>-0.10%</td>
<td>-0.05%</td>
</tr>
<tr>
<td>Amortized upfront securitization costs</td>
<td>-0.20%</td>
<td></td>
</tr>
<tr>
<td>Annual costs of guarantees and credit lines</td>
<td>-0.26%</td>
<td></td>
</tr>
<tr>
<td>Annual additional costs (systems, reporting, trustee fees, etc)</td>
<td>-0.25%</td>
<td></td>
</tr>
<tr>
<td>Effect on sponsor's marginal cost of capital</td>
<td>0.00%</td>
<td></td>
</tr>
<tr>
<td>Profits</td>
<td>5.48%</td>
<td>3.95%</td>
</tr>
<tr>
<td>Net savings from securitization</td>
<td>1.53% per annum</td>
<td></td>
</tr>
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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

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? No → Issue equity or mezzanine capital

Yes

Do the assets have a sufficiently high yield to cover servicing and other costs? No → Get out of the financing business

Yes

Would the assets be worth more (have a cheaper all-in funding cost) if they were isolated from the company/FI? No → Use assets as collateral for on-balance sheet debt

Yes → Securitize the assets

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