The Future of Securitization

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It's one of Wall Street's most important financing tools, and may hold a place next to the likes of **Coca-Cola** and Mickey Mouse as one of America's biggest exports. Securitization--the practice of reselling regular payments made by consumers on mortgages, credit cards and student loans--has indeed been readily embraced worldwide.

But, the process has come under greater scrutiny and plenty of criticism since the start of the credit crisis last summer. There have been questions about lending practices when it comes to bonds pooling mortgage debt and home equity debt, and some investors now question how certain securities ever attained a AAA rating to begin with.

The accusations of who is to blame for soured securities will probably be traded for some time and the pace of new deals pooling different forms of consumer credit may have dropped off from levels seen early this decade. However, Wall Street will probably never give up on the notion of reselling payment streams into bonds.

Investors like insurers, money managers and pension funds have come to rely on these asset-backed markets as a place to put their money to work, and Wall Street needs this financial tool to help finance anything from cell phone towers to buyouts of companies.

Also, the **Federal Reserve**, in an effort to shore up liquidity of the credit markets, may have given a not-so-subtle blessing to securitized products early this month when it allowed a greater variety of bonds backed by consumer debt to be used as collateral by banks in term securities lending facility auctions.

"The fundamental benefits of securitization are that you aggregate risk and you distribute segments of risk to people that find it more attractive than perhaps the whole. That basic function works and its been tested over many years," says **John Bonfiglio**, head of US structured finance for **Fitch Ratings**. "Long-term we're bullish on securitization."

As **Nicolas Retsinas**, director of Harvard University's Joint Center for Housing Studies, puts it, "I don't think you can put the tooth paste back in the tube." Making reference to **Daniel Webster**'s statement that credit is the vital air of the system of modern commerce, Retsinas says securitization has become the vital air of today's credit markets.

That may be true given that the ability to resell mortgage debt--something the Department of Housing and Urban Development's **Ginnie Mae** first did in 1970--has helped propel homeownership in America to nearly 70%. At the same time, the practice of securitization has allowed banks as well as finance companies to lend to a broader range of consumers who

spent money on goods and services, spurring economic growth.

Mortgage Debt Issuance ($ Billions)	Agency	NonAgency	Total
1996	440.7	51.9	492.6
1997	535.0	69.4	604.4
1998	952.0	191.9	1,143.9
1999	884.9	140.5	1,025.4
2000	582.3	102.1	684.4
2001	1,454.8	216.5	1,671.3
2002	1,985.3	263.9	2,249.2
2003	2,725.8	345.3	3,071.1
2004	1,375.2	403.8	1,779.0
2005	1,321.0	645.7	1,966.7
2006	1,214.7	773.1	1,987.8
2007	1,371.7	678.4	2,050.1
2007			
Jan	100.1	53.4	153.5
Feb	105.5	82.4	187.9
Mar	111.9	87.1	199.0
Apr	119.4	64.5	183.9
May	123.9	83.8	207.7
Jun	138.0	98.6	236.6
Jul	127.3	57.9	185.2
Aug	108.1	53.0	161.1
Sep	108.0	30.5	138.5
Oct	105.6	24.1	129.7
Nov	110.6	26.8	137.4
Dec	113.3	16.3	129.6
2008			
Jan	98.5	3.2	101.7
Feb	146.1	5.0	151.1
YTD '07	205.6	135.8	341.4
YTD '08	244.6	8.2	252.8
% Change	19.0%	-94.0%	-26.0%

Source: SIFMA

That repackaging of monthly mortgage loan payments and other consumer debt has also attracted a wider pool of investors such as overseas central banks. As a result, these foreign banks have in effect taken on the role as lenders to the American public--a role that traditionally was taken on by US thrifts which kept the loans on their books.

"Why would the central bank of China have [directly] financed a mortgage on 37 Maple Ave in Altoona, Pennsylvania" were it not for securitization, says Retsinas.

Democratization of credit

Securitization got its start with the reselling of the mortgage loan payments as bonds. The first government insured pass-through was done in 1970 by Ginnie Mae, and a year later **Freddie Mac** completed its own pass-through security. In 1977, **Bank of America** brought to market the first private-label mortgage securitization, and in 1983 Freddie Mac brought to market the first collateralized mortgage obligation, or CMO.

The stage for these mortgage bond transactions, though, was set in the 1930s when the US government created the **Federal Housing Administration**, which provided guarantees for 30-year mortgages. Until then, 30-year loans were not as common and balloon mortgages were more typical. Cookie cutter 30-year home loans made the creation of the first mortgage bonds easier.

The first securitizations were primitive. Known as pass-throughs, they merely passed on principle and interest payments from borrowers to investors who bought the bonds backed by 30-year home loans. The introduction of structured mortgage bonds known as CMOs allowed investors to buy highly rated debt that was protected from prepayments by support classes of bonds. This tranching process was then put into practice for other types of debt and helped investors buying AAA classes protect themselves from any problem loans.

In 1996, $440 billion worth of bonds backed by loans with a Freddie Mac or **Fannie Mae** guarantee were issued on Wall Street, while nonagency mortgage bond issuance totaled $51.9 billion. In 2003, agency debt issuance totaled $2.7 trillion, and in 2006 non-agency issuance was at $773.1 billion. Last year, agency mortgage debt issuance was at $1.3 trillion and non-agency debt issuance was at $678.4 billion.

A recipe that works

In its early years, much of the securitization process involved mortgage loans for single-family homes. By the 1990s, Wall Street dealer firms resold monthly payments for commercial real estate mortgages as well as other consumer debt such as credit cards and auto loans.

In 1996, the dominant asset-backed debt was credit cards, with some $186 billion worth of deals, but by 2006 this had shifted to bonds backed by home equity loan debt. Nearly half a trillion dollars worth of home equity loans were resold as bonds on Wall Street in 2006.

What drove this change? Home values rocketed higher steadily after a series of rate cuts by the Fed meant to buttress the financial system in the wake of the Sept. 11 attacks on the US. The low rates--and steady gains in home values--allowed consumers to borrow more money using their homes as equity. This money was used to pay down auto loans, student debt and credit cards. Some of the draw to home equity loans was that, unlike other consumer debt, consumers could write off some portion of their second-lien mortgage payments. They found that, after taxes, the cost of borrowing with a home equity loan or line of credit was less than that of credit cards.

In recent years, Wall Street dealer firms used the securitization process to create greater numbers of collateralized debt obligations, or CDOs. Initially used as a tool to lighten up bank balance sheets, CDOs were embraced by fund managers who would buy undervalued-usually lower-rated mortgage bonds-and resell them as higher rated securities within a CDO.

CDOs included lower rated classes of home equity debt, commercial real estate debt and net interest margin securities or NIMs.

The securitization process in the last decade also was applied to a wider range of esoteric streams of income. Expected music royalties for songs written by rock musician **David Bowie** and soul musician **James Brown** were resold as bonds. Music publishers, too, created bonds backed by royalty payments and some film studios raised money by selling bonds backed by expected income from ticket sales. In recent years, the idea was been applied to income generated by cell phone towers and it could be used by local governments who need to raise money for infrastructure improvements in coming years.

While the pace of creating bonds backed by credit cards and auto loans has ebbed slightly, the supply of these securities is up dramatically over the last two decades.

In 1985, the asset-backed market saw issuance of $1.2 billion. In 1995 $113.1 billion worth of asset-backeds were sold on Wall Street and in 2006 $1.3 trillion worth of asset-backeds were completed. Last year issuance dropped to $901 billion. The pace of new deals backed by student loans and credit cards as well as auto loans is expected to continue to decline this year.

What's next?

Issuance of bonds backed by mortgage loans has dropped this year because many investors are wary of securities pooling home loans at a time when homes are still losing their value. Also, signs of a slowing economy have spurred concerns about consumers' ability to make good on their various forms of debt.

At the same time, investors are demanding such yield premiums or spreads that it is tougher to offer mortgages with low rates. In some cases investor demand is just not there, so loans to less credit-worthy borrowers or borrowers that could qualify for Alt-A home loans are not being offered by lenders.

In the commercial mortgage-backed securities market, a drop in the issuance of new deals has slowed underwriting of loans, according to **Lisa Pendergast**, head of commercial mortgage-backed bond research at **RBS Greenwich Capital**. "The inability to originate loans is because of the wide spreads in CMBS," she says, adding that "this pushes mortgage rates higher."

Not all lending in the residential and commercial real estate finance world, though, has stopped. Insurance companies have stepped up their role as lenders because they can retain commercial real estate mortgages in their portfolios and don't rely on securitization. And, some large single-family mortgage loans known as jumbo mortgages are being offered by lenders who often retain the loans on their portfolio.

At the same time, the US housing agencies have, on a temporary basis, been allowed to sell guarantees for larger mortgages which could result in a pick up in issuance of agency or conforming mortgage bonds.

While it has been out of the public's eye until last summer, Wall Street's securitization engine has played a great role in the US economy. Indeed, economists have voiced concern about what a slowdown in issuance of securities backed by consumer debt and a decline in investor demand means for the broader economy.

In November, **Goldman Sachs**' economists warned that losses in the mortgage debt market could put off investors from lending by as much as $2 trillion and this could result in a "substantial" drag on the US economy.

"If leveraged investors see $200 billion of the $400 billion aggregate credit loss, they might need to scale back their lending by $2 trillion," the report said, adding that "even if this occurs gradually, and even if there are some offsets from reduced credit demand and increased lending by other sectors, the drag on economic activity could be substantial."

That report pointed out that losses in the mortgage market may not appear to be as large as those that could be seen in the stock market, but the losses in the mortgage mart are borne by leveraged investors.

Citing a paper by New York Fed economist **Tobias Adrian**, Goldman's economists noted that "leveraged players actively scale back lending to keep their capital ratios from falling. For example, a bank that targets a constant capital ratio of 10% needs to shrink its balance sheet by $10 for every $1 in credit losses."

Fitch's Bonfiglio agrees with the notion that securitization plays a role in the overall economy. After all, he says, "so few things that people buy are paid all with cash so lending is an important part and securitization is equal if not larger part of lending than the traditional banking system. It's basically a second banking system."

New transactions being staged

Yield premiums for asset-backeds, meanwhile, have narrowed since the Fed orchestrated **JPMorgan**'s purchase of **Bear Stearns** and this, in turn, has spurred issuance of asset-backed bonds. Within the asset-backed arena, credit card-backed bonds have dominated the influx of new offerings.

According to a recent report by **UBS**, 2008 has so far seen $40.5 billion worth of new credit card deals, up slightly from year-ago levels. Auto loan and auto lease-backed deals are at $23.1 billion, up from $17.1 billion during the same period a year ago. Bankers likely were cheered by the completion of a $750 million deal backed by subprime auto loans from **AmeriCredit**. That transaction was actually increased from $500 million.

At the same time, student loan-backed bond issuance is down 35% from year-ago levels. Wall Street has, to date, sold $16.2 billion worth of student loan backed bonds.

While these areas have seen issuance, some important sources of fees for Wall Street firms have not reemerged this year. For example, no home equity, dealer floorplan-backed bonds, aircraft loan and lease securities have been completed this year.

However, there are signs that the pace of securitization activity in the US and overseas continues to pick up.

Last week, there was talk of a $1 billion credit card bond from JPMorgan Chase, as well as a commercial mortgage backed issue from **Merrill Lynch** backed by just over 90 commercial real estate mortgage loans on 400 properties. There was also a deal pooling mortgage loans originated by **Halifax** and mortgages underwritten by **Bank of Scotland** under the Halifax brand. In Asia, a deal was being readied by **Korea Ace Mortgage Company**, the first issue of notes backed by a pool of residential mortgage loans originated by **Citibank Korea Inc**.

In France, meanwhile, bankers readied a bond pooling consumer loans by Cetelem, a subsidiary of **BNP Paribas**.

Off-the-run deals getting done

While asset-backed issuance is off dramatically and most deals these days are transactions featuring plain vanilla collateral or simpler structures, some unique transactions such as deals backed by structured settlements from **JG Wentworth** have been completed.

The Bryn Mawr, Pa., firm lends money to individuals who have been awarded settlements such as in personal injury cases. In many instances, the individual will want to get the money up front as opposed to being paid the settlement over a period 20 or 30 years. The settlements are then resold as bonds, which can total $100 million; each is backed by 1,800 to 2,000 settlements.

John Calamari, CFO of JG Wentworth, says his firm has done $1.7 billion worth of deals since 1997. Initially, the firm had to structure to bonds with 16% subordination, a level of protection, but today the deals are done with 5.5% subordination, suggesting investors and rating agencies are more comfortable with the unusual collateral. "It is the perfect product for pensions, insurance companies and big banks," says Calamari.

While JG Wentworth's deals, like all other asset-backed deals since last summer, have been

sold at a wider spread level, they are being completed. Securitization, says Calamari, is a valid source of finance. "A year ago, more was being done, but deals are getting done."

Calamari scoffs at the notion that securitization will ever completely fade. "Capital market securitization is another form of credit that's distributed. It would be equal to saying there won't be any banks anymore."

Asset Backed Debt Outstanding
$ Billions

	Automobile Loans	Credit Card Receibables	Equipment Leases	Home Equity Loans	Manufacturing Housing	Student Loans	Other	Total
1996	71.4	180.7	23.7	51.6	14.6	10.1	52.3	404.4
1997	77.0	214.5	35.2	90.2	19.1	18.3	81.5	535.8
1998	86.9	236.7	41.4	124.2	25.0	25.0	192.3	731.5
1999	114.1	257.9	51.4	141.9	33.8	36.4	265.3	900.8
2000	133.1	306.3	58.8	151.5	36.9	41.1	344.1	1,071.8
2001	187.9	361.9	70.2	185.1	42.7	60.2	373.2	1,281.2
2002	221.7	397.9	68.3	286.5	44.5	74.4	449.9	1,543.2
2003	234.5	401.9	70.1	346.0	44.3	99.2	497.7	1,693.7
2004	232.1	390.7	70.7	454.0	42.2	115.2	522.9	1,827.8
2005	219.7	356.7	61.8	551.1	34.5	153.2	578.2	1,955.2
2006	202.4	339.9	53.1	581.2	28.8	183.6	741.4	2,130.4
2006								
Q1	220.3	359.8	60.7	552.6	33.5	162.9	575.7	1,965.5
Q2	215.3	354.4	60.4	564.7	32.4	175.5	583.1	1,985.8
Q3	212.0	352.9	57.6	574.8	29.9	182.0	607.5	2,016.7
Q4	202.4	339.9	53.1	581.2	28.8	183.6	741.4	2,130.4
2007								
Q1	202.6	338.1	50.6	583.4	28.7	199.4	835.3	2,238.1
Q2	201.5	335.1	50.4	592.6	27.8	214.9	993.2	2,415.5
Q3	199.1	342.7	47.9	596.0	27.7	236.0	1,027.9	2,477.3
Q4	198.5	347.8	46.2	585.6	26.9	243.9	1,023.5	2,472.4

Source: SIFMA

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