

Securitisation Report

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Differentiating, Valuing and Regulating Securitisations

Introduction

Securitisation has been subject to a certain degree of scrutiny recently, in particular regarding its role in the problems associated with the banking sector. Nevertheless it is important to differentiate between the various types of securitisation because where there are good levels of transparency and data availability, securitisation can spread the risks of funding and make financing work more efficiently.

Securitisation is a particular type of secured financing that can delink a transaction from direct corporate risk or exposure to a concentrated group of assets. A variety of secured financing structures developed in recent years to meet an increasingly sophisticated range of investor demand and some of these transactions grew to be very complex and, in a number of instances, lacked a level of transparency needed by the markets to have confidence in their true value.

The future of securitisation will need to focus on greater transparency regarding the identification and quantification of a wider range of risks, including credit risk, liquidity risk, market risk and the risk of price volatility. The relationship between the probability of a particular risk (or set of risks) crystallising, and expected investor returns for given risk scenarios underpin how securitisations and the associated underlying assets should be valued.

Recent government interventions to support financial institutions and the stability of the financial markets have increased the likelihood that there will be greater regulatory scrutiny of securitisations in the future. In this context, the differences between securitisations should be recognised and reflected in any changes to their regulatory treatment.

Differentiating Securitisations

Multi-borrower Securitisations

There are several types of multi-borrower securitisations that are underpinned by a diverse security pool with different risk profiles. This diversification underpinned the spreading of risk and the ability to increase leverage against this. These of multi-borrower securitisations include; asset backed securities (ABS) which are securitisations underpinned by assets such as credit card and automobile agreements or corporate assets; residential mortgage backed securities (RMBS) which are securitisations underpinned thousands of individual residential mortgages; commercial mortgage backed securities (CMBS) which are securitisations backed by single or multiple commercial tenants; and collateralised debt obligations (CDOs), are securitisations of existing loans, and can have more than one class of security providing underlying collateral to these loans.

The popularity of CDOs has grown as issuers have sought new and innovative ways of finding collateral against which to raise debt. Overly complex structures that have been associated with certain CDO transactions reflect not only the re-securitising ABS and MBS securitisations, but also securitising existing CDOs. Such structures theoretically spread risk even further allowing even greater leverage, however at the same time it can increase the sensitivity to changes to certain assumptions, such as regarding underlying asset performance and correlation risk. Because multi borrower transactions rely on the relatively recently introduced techniques of diversification and debt tranching and there is less of a track record of performance over credit cycles, the level of appropriate historical data that is available is limited.

Single-borrower Corporate Securitisations

Single borrower corporate securitisations do not benefit from the levels of diversification associated with multi borrower transactions, and are exposed to operating risk in a more direct way. Having said that, corporate related debt holders typically benefit from better data availability, in particular historical profit and loss performance, which is usually widely published and relatively easy to model. Industry experts, who have a strong understanding of the associated cash flows that underpin asset valuations, typically undertake the credit analysis of single borrower securitisations.

Because many corporates can demonstrate historic cash flow performance through business cycles, the stresses associated with highly rated amortising cash flow based transactions tended to result in lower levels of leverage than compared to securitisations based on asset values. Increasingly therefore corporate securitisations came to be based on the analysis of the underpinning assets and the stresses applied to the asset values that had become artificially inflated as a consequence of the availability of cheap money.

Tranching Considerations

The debt associated with securitisations is frequently tranced in order to repackage risk and create various classes of debt with different rights over defined assets and cash flows. This means that owners of senior tranches are protected by sub-ordinate tranches in the same transaction, because in the event that a transaction was under-performing, any losses would be first taken by the subordinate tranches. Tranching allows significant proportions of senior debt tranches to achieve high credit ratings, and allowed for a greater overall level of leverage than would otherwise be the case without tranching. Underpinning the analysis of tranching was the assumption that senior debt tranches would be repaid under all foreseeable scenarios from the ultimate sale of underlying assets.

Lack of supporting historical data meant that there is a certain degree of opacity surrounding the different tranching levels and their assumed respective default and loss levels. Furthermore, the lack of historical data also makes it difficult to assess the risk of migration of tranches across different rating categories when market conditions change. Some securitisations include many tranches of debt, and this can add to the level of complexity for investors. At the end of the day, however, the different tranches of debt are secured on the same assets, and regardless as to the degree of structuring any decline in the value of these assets is likely to have an impact on the perception of risk across all tranches.

Hedging Considerations

To bring greater certainty to investors, securitisations typically include hedging arrangements to offset the risk of factors over which the owners of securitisation have no control, such as currency or interest rate movements. Hedging can also be used to offset the risk of a default in a transaction, through the use of credit default swaps where the risk of default is essentially insured by a highly creditworthy counterparty. However, by using hedging arrangements to divest themselves of risks, investors may be more inclined to take on additional risk and in theory this could offset the benefits of spreading risk through hedging arrangements in the first place. This situation crystallises in the event an insurance provider itself defaults.

As credit ratings became less of a predictor of price and perceived market risk, investors turned to other indicators to help price securitisations including using credit default swap indices. Pricing data was relatively easy to obtain in support of such indices as hedging instruments could be traded without having to take security interests in the underlying transactions. However, because such indices were relatively new, again there was no historical data availability that could predict future behaviour at different points in the credit cycle. More recently prices for hedging

instruments have been quite volatile in the face of adverse events. For example, when AAA tranches of securitisations were downgraded by the rating agencies, the potential liabilities of the credit default swap counterparties increased, thereby reducing their own creditworthiness and the value of the hedging protection they were underwriting.

The impact of the market volatility that followed the rapid growth in hedging arrangements in support of securitisations may yet be fully realised, and the reduction in the creditworthiness of counterparties of hedging arrangements could lead to an early termination of such arrangements, resulting in an unwinding of positions that could create even greater pricing volatility and uncertainty regarding the value of securitisations.

Valuing Securitizations

Liquidity risk vs. Credit risk

The growth in securitisations coincided with an extended period of low interest rates and increasing values of the assets that underpinned these transactions. This in turn allowed more debt to be borrowed against the continually rising asset values each time the transactions were refinanced, and encouraged new transactions to be brought to the market.

Furthermore, the growth in demand for shorter-term transactions, where very little or none of the outstanding principal would be amortised meant that this growing amount of securitised debt relies on refinancing after a few years. In the event that refinancing is not forthcoming, it is assumed that the sale of the underlying secured assets would be sufficient to meet repayment obligations. For rated securitisations the level of asset over-collateralisation relative to the outstanding debt is a key factor in the rating outcome, and any fall in the value of this underlying collateral is likely to have rating implications.

The drying up of liquidity since mid 2007 has in particular exposed such short-term transactions that rely on refinancing. In addition, where certain investors have to report marked to market positions, this has caused a crystallisation of losses resulting in forced selling which in turn has served only to exacerbate price falls to levels that in many cases may not reflect the intrinsic value of the asset.

In an environment where leverage was increasing based on expectation of available liquidity and increasing asset values, the underlying analysis of credit risk became a less important part of the pricing process. Instead a greater emphasis is placed on liquidity risk and market sentiment, and consequently there was a growing disconnection between the valuation of securitisations and the underlying credit risks. When this situation reversed itself, with liquidity less available and asset values falling, there is a risk that this disconnect will continue. However this time assets may be undervalued in the short term relative to the intrinsic or fair value based on an analysis of the underlying credit risks over the medium to longer term.

In the future there will need to be better transparency regarding how liquidity risk may impact the valuation of securitisations. Liquidity risk is different from credit risk as it reflects lenders' cash needs to meet their future obligations. Liquidity risk reflects a number of factors including size of issue, history of trading of a particular type of issue, the complexity of the issue structure, and the

size of the investor community willing to acquire such issues. In many ways assessing liquidity risk is less straightforward than assessing credit risk, as there are no available liquidity ratings in the same way there are credit ratings. Nevertheless, factoring in less optimistic assumptions regarding interest rate movements and discount rates as a proxy for liquidity risk may need to be more widely used in the future.

It is worth noting that credit ratings reflect an opinion on default risk and ratings are not necessarily a measure of market perceptions of credit quality. In the same way that better liquidity risk measures should be developed, more market based measures of credit risk, perhaps interpreting credit spread data linked to default ratings, would be a helpful element in valuing securitisations.

Shortcomings of mathematical modelling

The analysis of many complex securitisations typically rely on quantitative modelling techniques, despite the fact there is often limited supporting historical statistical data available making it difficult to look back to performance over economic cycles.

While these quantitative models were good at testing and measuring risk when certain key assumptions held to be true, they could not be relied on when the assumptions were no longer true, as was the case for example when liquidity in the market dried up and asset performance became more closely correlated. The models used proved to be only as good as the key input assumptions and quality of underlying data, and in many instances there were over optimistic assumptions regarding the availability of liquidity and insufficient data to adequately measure underlying risks.

Although models appeared complex in their construction and functionality, they could be sensitive to a relatively narrow a range of risk assumptions. Furthermore it could be argued that in certain instances there was an over-reliance on mathematical outcomes rather than taking a more pragmatic scenario planning approach, particularly regarding the likelihood of changing risk profiles over credit cycles, and the likelihood of key factors being correlated (for example, an increase in interest rates leading to more defaults which in turn leads to falling asset values). The over reliance on models and the certainty of their outcomes, could result in the failure to adequately pick up a key event or combination of events that was deemed to have a low probability of occurrence given a particular set of assumptions but when these assumptions changed so did the probability of occurrence, with significant impact on valuation.

Analysing Valuations

In broad terms, valuations should reflect the probability of default, the likely recovery values in the event of default, and the correlation of default across borrowers in a portfolio. Valuing the assets, the business, and the debt associated with a particular securitisation can be approached differently with different internal and external factors driving the valuation amount. Valuations can also be different for different investors, for example between equity and debt investors and between short term and longer-term investor.

Valuations should test a wide range of risk assumptions based on a scenario planning approach, informed as far as possible with data over previous credit cycles, albeit recognising that credit cycles are not always the same. Where directly relevant past performance data is not available, then historical proxy data from appropriate benchmark transactions should be sought. As well as making assumptions that may or may not result in losses, scenarios could also be developed that assumes a certain level of loss in the first place and then seeks to construct a range of factors that could have caused such an assumed loss and the probability of their occurrence.

Asset valuation can be assessed using discounted cash flow calculations that reflect certain assumptions regarding future interest rates and net cash generation. The assumptions and values are typically benchmarked against similar assets in the market at the time, and consequently can be strongly influenced by market sentiment leading to overly optimistic or overly pessimistic assumptions and values. It is important therefore that an intrinsic value is identified which sits in the middle of a range of valuations that reflects market sentiment at a particular point in time in the economic cycle. The most difficult element to model in a valuation is market sentiment and the motivations that underpin such sentiment, nevertheless where possible using historical data of changes to valuation over a cycle may help predict future price movements relative to current price.

Focusing on a relatively narrow range of factors to assess the valuation of an asset at a certain point in time has typically not been able to reflect the recent volatility in asset prices. The challenge for investors in the future is to encompass, as far as possible, a wider range of factors in their assessment of value. In order to achieve this on a practical basis, it is likely to mean that transactions will need to be less complex in the way they are structured so that the different factors that may impact asset value can be better identified and quantified.

The wider range of factors should take into consideration number of areas of risk including; credit and default risk, liquidity risk, and market risk. An analysis and interpretation of these risks, over given time horizons, should drive the assessment of value.

Risks can be quantified by reference to historical experience and these can be used to interpret future scenarios. Where historical data is not available, proxy data can be sought. That said, investors should consider what are appropriate scenarios and link these to a common sense approach to risk management, rather rely on the outcomes of mathematical formulae. Identified risks and combinations of risks can be modelled to provide a distribution of results. For given level of statistical confidence over a given time period, investors can assess a level of risk based asset valuation with a greater degree of transparency.

Investors with different appetites for risk and reward are able to trade off greater or lesser level of confidence for the crystallisation of risks. The greater the level of confidence, the more certainty there is for a given loss or profit. This in turn can be reflected in the rate of return required by investors.

The asset valuation in the future will therefore need to be more risk driven based on scenario planning and less reliant on over complex quantitative models. Instead a quantitative approach that measures value should be developed that will need to be transparent and will need to identify the intrinsic risks associated with a transaction. Where an appropriate level of transparency is not forthcoming investors are likely to factor in a bigger risk premium.

Regulating Securitisations

In the same way that there is a risk that securitisations are valued too pessimistically relative to their intrinsic value, there is also a risk that regulators in the European Commission over regulate securitisations relative to their real risk profile. Initial discussions in Europe have suggested that securitisations of assets originated by banks will be quite heavily risk weighted and accounted for on bank balance sheets.

It would be unfortunate if securitisations in Europe pay an unfair price because of less well regulated securitisation in the US in recent years. Securitisations would be better served by a more sensitive system of regulation that reflects the different risk profiles associated with different types of securitisation. Securitisation when properly regulated on a global basis can make financial systems work more effectively. A blanket and misguided regulatory response to short term considerations may have longer-term negative consequences.

Regulation will need to address the excesses of securitisation that occurred in recent years, in particular the more complex and opaque transactions that led to a mis-pricing of the risk of these transactions and an over-leveraging of banks balance sheets. There is likely to be a return to more on-balance sheet lending, but where there is an appropriate level of transparency that allows investors to reflect the true risk of the transaction in the price, then these securitisations should not be prevented from taking place and improving the efficiency of international capital allocation.

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