

Securitisation: Current Concerns and Long-term Value

Securitisation: Current concerns and long-term value

Paul Lejot, Douglas Arner & Lotte Schou-Zibell
Manila, 15 February 2008

Asian Institute of
International Financial Law
University of Hong Kong

Asian Development Bank
Office of Regional
Economic Integration

Scope

- Highlights of OREI working paper
- Securitisation mechanics, drivers and contractual imperatives
- Subprime's 2007 crisis, systemic consequences, and official responses
- Post-crisis prospects in East Asia

Securitisation: Current Concerns and Long-term Value

Working paper highlights

- Asian securitisation widely permissible, and understood by originators and investors
 - But usage is costly, below expectations and not expanding
- Widespread supportive reforms since 1997-98 (see table 8)
 - Yet institutional obstacles persist (table 7)
- Use constrained by broader national policies ... and inconsistent underlying drivers

Working paper highlights

- Empirical analysis suggests usage linked to financial market deepening, credit creation, general growth, and NPL volumes
- No evidence that 'financial system evolution' will induce greater use in Asia
- Where adopted, Basel II Pillar 2 (supervision standards) may raise transaction feasibility
 - Widely unresolved pre-1997 concern

Securitisation: Current Concerns and Long-term Value

Types and uses

- Funded or unfunded credit risk transfer, using
 - Cash and synthetic securitisation
 - Covered and structured covered bonds
- Commercial motives in funding costs, balance sheet management, stability and risk management
- Shift activity from an organisation to a contractual setting
- Financial sector use induced by regulation

Institutional demands

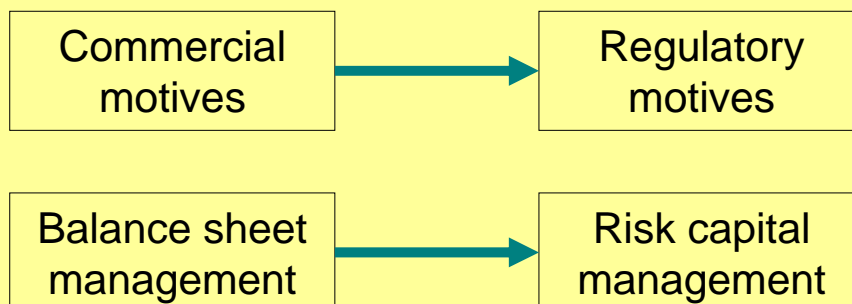
- Legally and contractually intensive
 - Reliance on tranching and credit enhancement
 - Many parties involved throughout
- Requires highly effective transaction formation, execution and management
 - Significant data and modelling dependence
- Contractual completeness and monitoring incentives essential

Securitisation: Current Concerns and Long-term Value

Mechanics & drivers

- Long-standing transaction cost motives
 - Medium for funding and portfolio investment
 - Well-established uses in corporate disaggregation and project finance
- Contractual financial intermediation lessens risks inherent in traditional lending
 - Transparent and risk averse
 - Supportive of credit creation

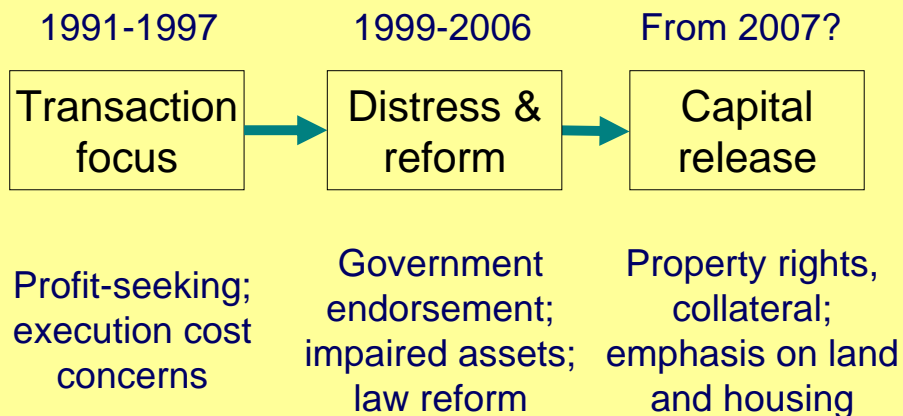
Long-term global drivers



From the 1970s ... to Basel II
Elective strategy to regulatory arbitrage

Securitisation: Current Concerns and Long-term Value

Varying drivers in East Asia



Regulatory incentives

- Rapid, unanticipated and profound change in capital costs from Basel I
 - Not wholly eliminated by Basel II
- Focus on regulatory capital management
 - Thus 70% of Northern Rock loans 'sold' but not balance sheet defeased end-2006
- Increasingly elaborate and opaque structures
 - SIVs and off-balance sheet conduits
 - Vital rating agency dependent

Securitisation: Current Concerns and Long-term Value

Crisis of 2007

- Subprime downturn exposed predatory lending, unwarranted leverage and poor credit standards
- Formerly, credit risk transfer widely favoured
 - But risk dispersal narrower than predicted
 - Funded risk concentrated in banks
- Paralysis in all structured markets
 - Contagion in elemental sectors
- Contractual intermediation cannot compensate for weak loan origination and management

Fallout

- Re-examine global use of 'unusual' US model
 - Active rating agency origination involvement
 - Undercapitalised monoline insurers give only limited credit substitution
- Radical change in transaction economics
- Sharp fall in regulatory capital transactions and off-balance sheet structures
- Change in rating agency standing
 - Cut conflicts and quasi-official functions

Securitisation: Current Concerns and Long-term Value

Solutions

- Contractual enforcement
 - Not ubiquitous in common law systems
- Contractual transparency
 - Scrutiny of credit appraisal, and ongoing transaction management
- Reduction in leverage and transactional regulatory arbitrage
- Return to economic drivers for securitisation
 - Highly appropriate for infrastructure funding

Official responses

- Crisis response and resolution mechanisms
- Supervisory framework
 - Design, consistency and effectiveness
 - Basel II securitisation framework and permissible internal predictive risk models
 - Rules for minimum liquidity and price formation
- Rating agency sanctioning and operations
- New standards in transparency and disclosure

Securitisation: Current Concerns and Long-term Value

Future applications

- Use in Asia increasingly to mirror use elsewhere
- Examples
 - Refunding of microfinance lenders in agricultural and community projects
 - Credit support for education and human resource development
 - Financing infrastructure
 - Investment medium for provident schemes

Securitisation: Current concerns and long-term value

Securitisation in East Asia

Paul Lejot, Douglas Arner & Lotte Schou-Zibell

OREI Working Paper No 12

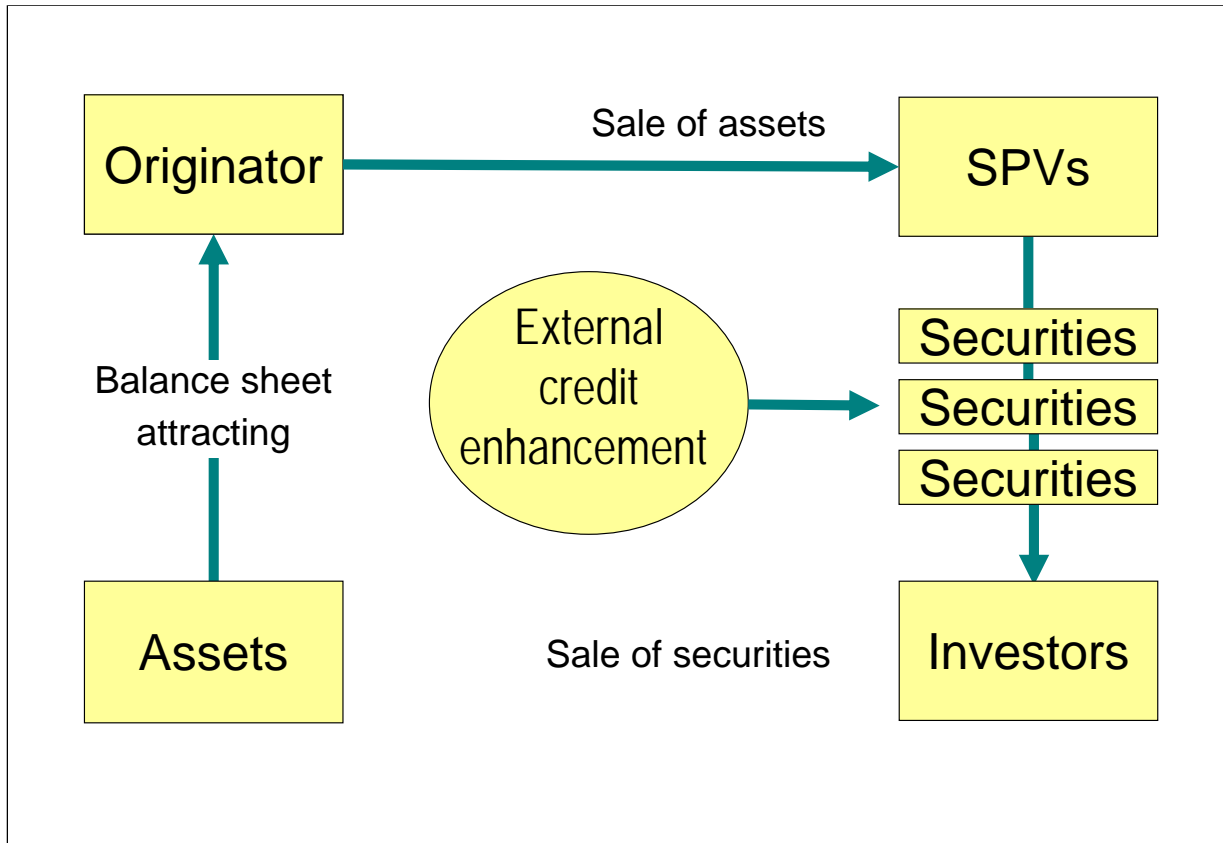
January 2008

<http://aric.adb.org/res.php>

Illustrations & tables

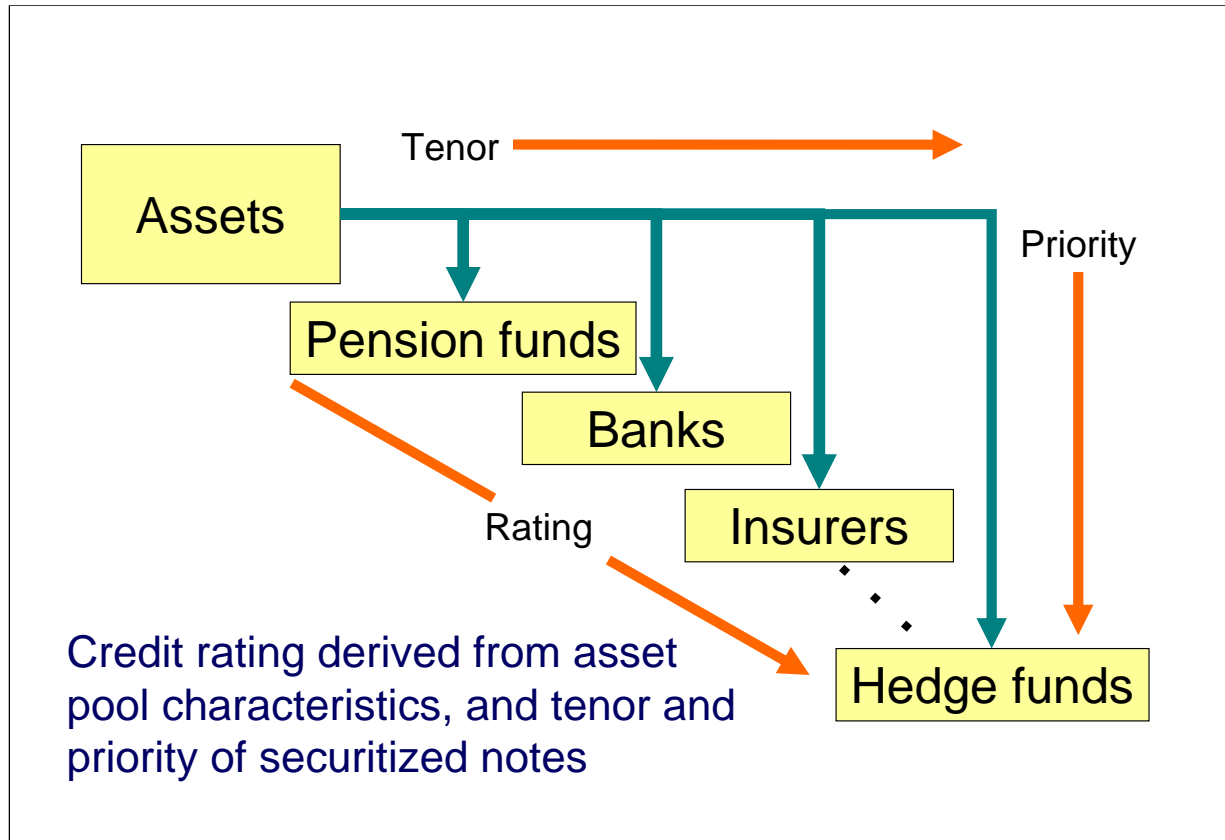
1. Generic cash securitization

- Financial assets are sold by their originator to an insubstantive SPV, usually in a shared domicile.
- The SPV funds the purchase, immediately or after a short period for asset accumulation, with an array of new securities enjoying direct claims of varying seniority over all or part of the pool of assets.
- Securities created with the sale may be acquired at issue or bought and sold later by any investor.
- Qualifying assets may include impaired assets, commercial mortgage loans, corporate loans and major lease receivables.
- Loan or asset administration usually becomes independent of the originator.
- The originator may continue to deal commercially with any ultimate debtor except in cases involving impaired assets but to obtain balance sheet relief may not usually derive ongoing benefits from claims becoming subject to the sale.



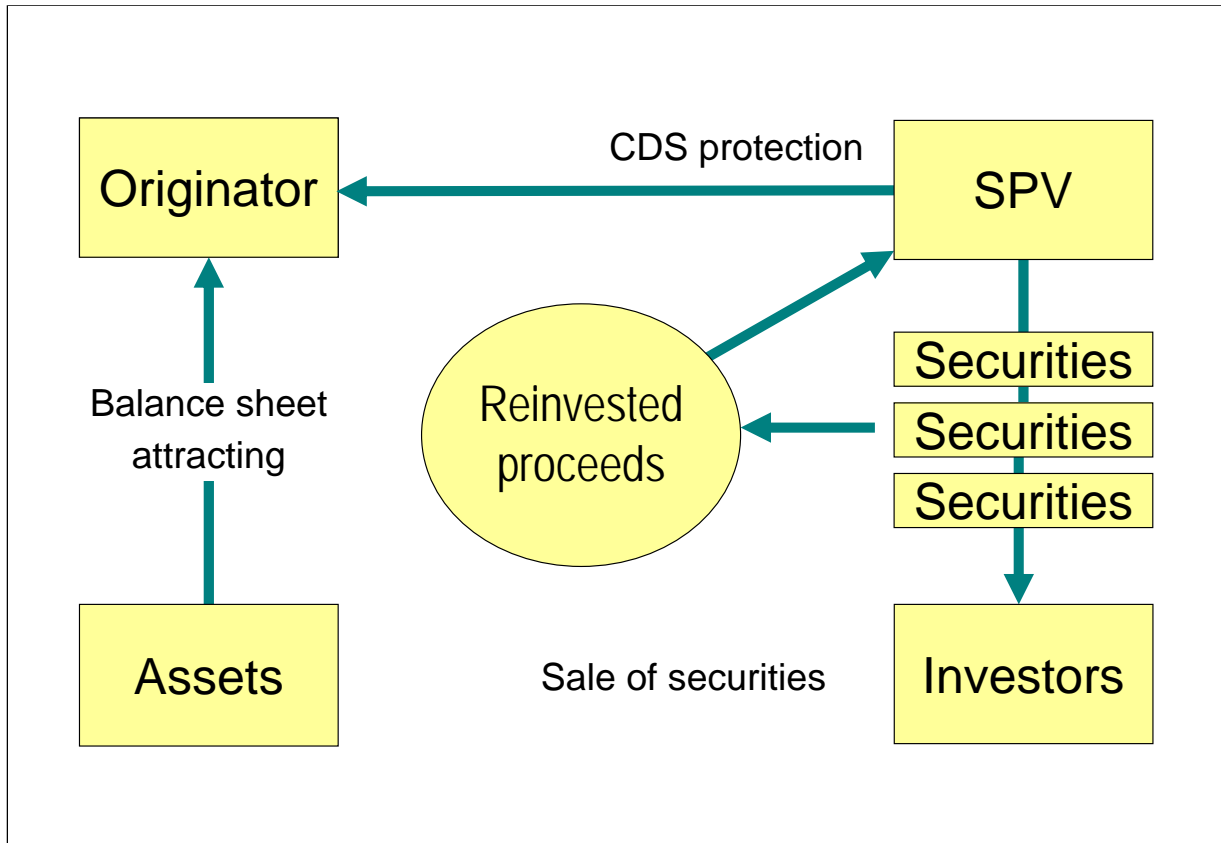
2. Credit ratings and risk-return trade-off

- Securities (typically notes, bonds or commercial paper) are issued in tranches to meet required target credit ratings and the risk-return preferences of segmented classes of investors, while extracting the fullest economic use of pool cash or proceeds.
- Value is first extracted from the asset pool internally.
- External sources of credit then provide additional tangible contingent support such that each series of bonds meets a target initial credit rating.
- This is achieved through iterative consultation between transaction arrangers and at least one rating agency.
- Such external backing is facilitated by additional third party support by means of funded or contingent capital, guarantees or dedicated insurance. It may cover defaults within the collateral pool or an entire transaction, and in cross-currency transactions will include specific credit support to induce the participation of a currency swap counterparty.



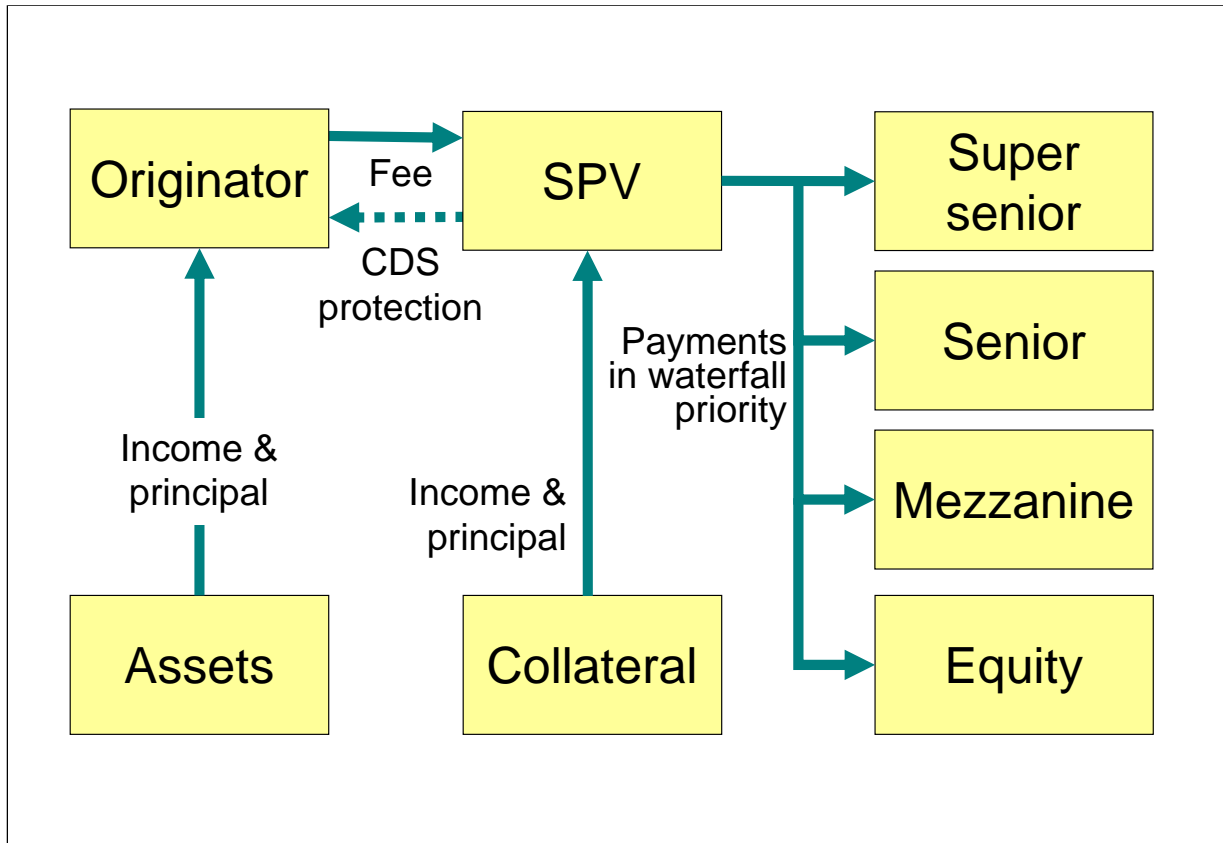
3. Generic synthetic securitization

- Synthetic transactions provide originators with credit risk support through an array of credit derivatives, thus altering the risk composition of the source balance sheet.
- Investors thus enter a transaction with different legal rights to a cash securitization, but which may fully replicate the risk-return qualities of one or more tranches of such a transaction.
- This simple example is a template for more complex deals. Proceeds from the sale of securities are devoted to buying credit protection structured to meet the expected risk performance of the originator's asset pool.
- In effect, the originator buys bespoke credit protection funded by the sale of an irrevocable interest in its risk portfolio.
- The significant difference in transaction economics between cash and synthetic deals is that the proceeds of the sale of securities stay within synthetic transactions and can help service the claims of investors, for example, by making or replenishing a cash reserve for scheduled payments.



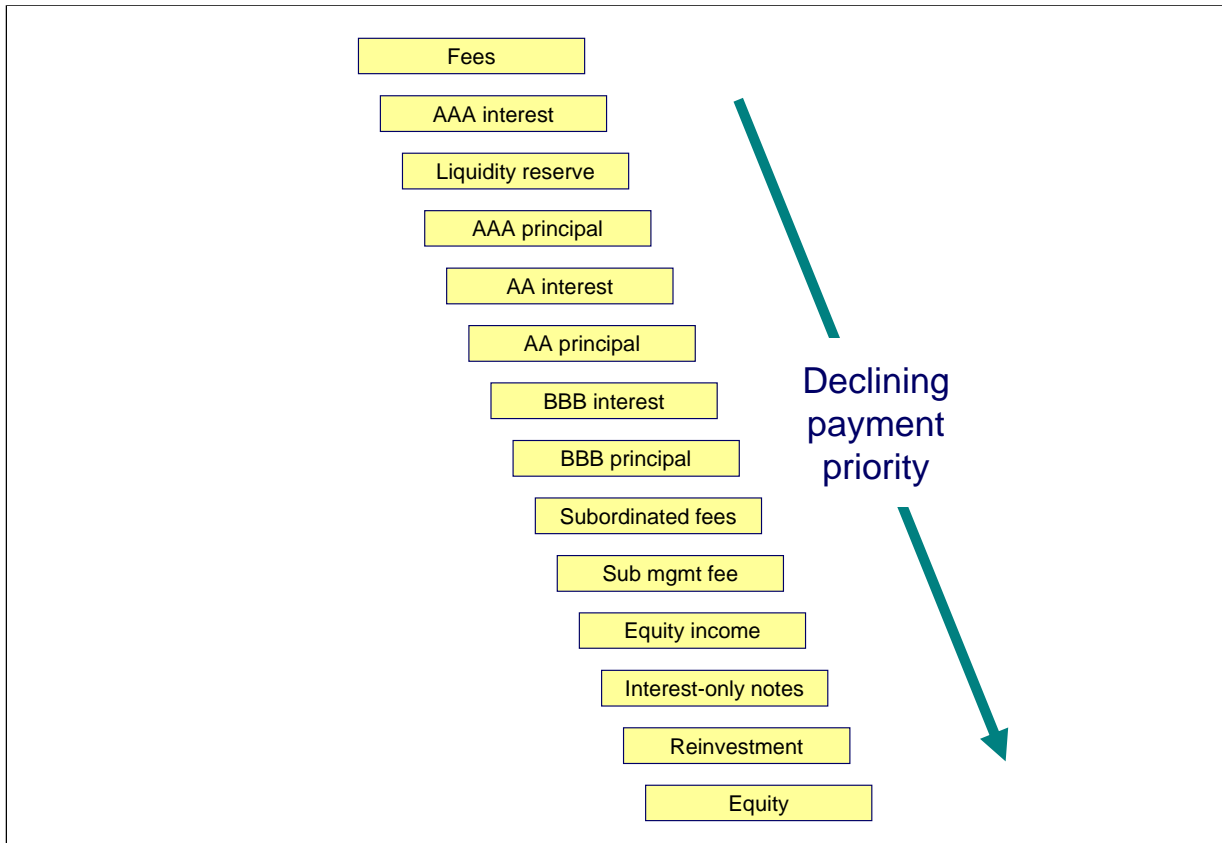
4. Simplified CDO structure

- The transaction economics of synthetic structures are aimed to a greater extent than cash deals towards credit rating augmentation.
- This requires an array of CDS, and a diversified investor base that allows the sale of deeply subordinated tranches, or 'equity'.
- In many cases prior to the 2007 market dislocation, these most junior claims would be retained by the originating bank, and thus erode the regulatory capital advantages of the overall transaction. Basel II removes the incentive for this approach in all but the most extreme cases, for example, a highly over-capitalized closely-held bank.

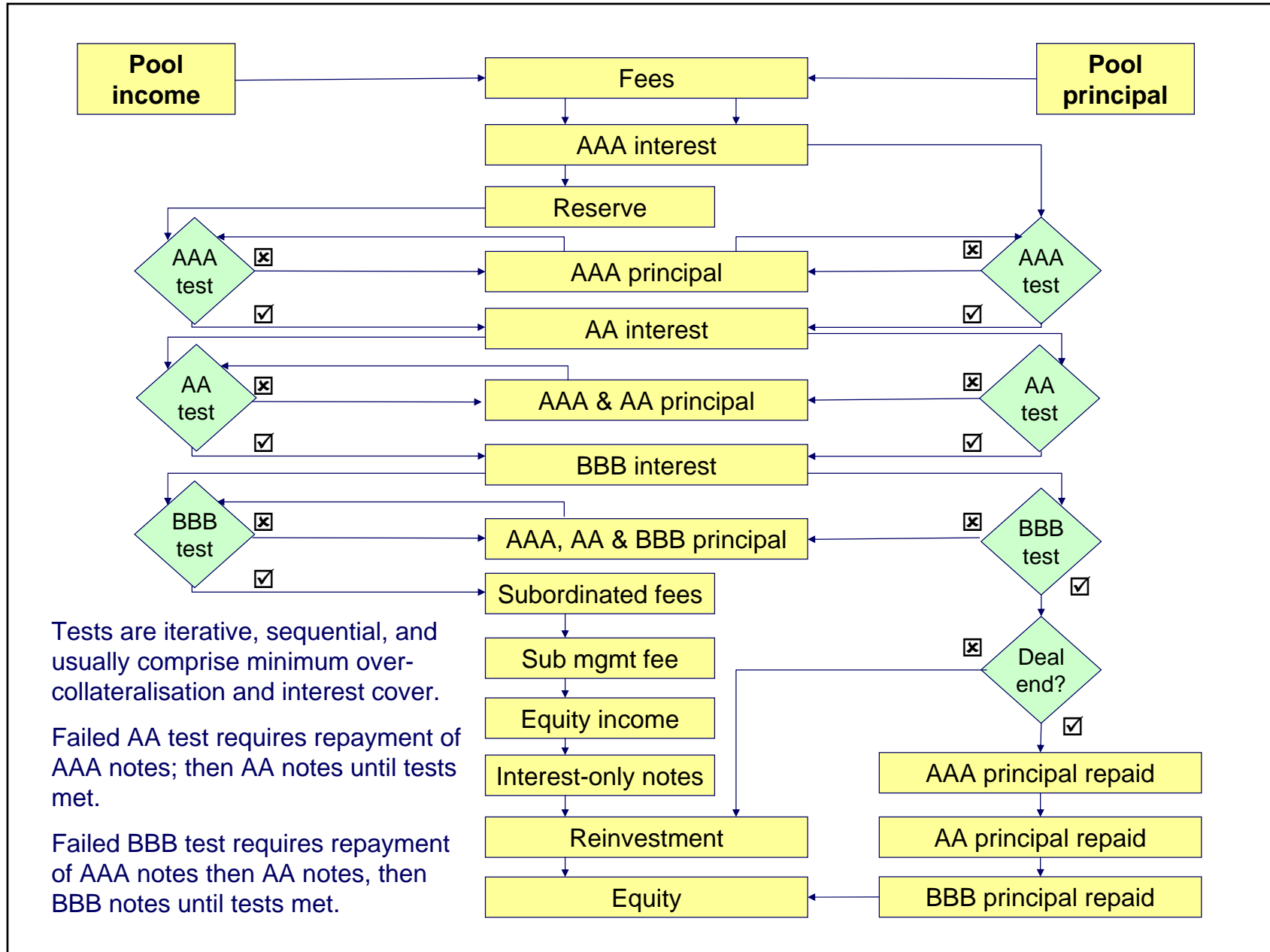


5. Simplified CDO payment waterfall

- Strict priority applies iteratively to all incoming pool payments at all stages in the life of the transaction.
- Each pool payment follows the waterfall's course.
- Priority is absolute at all times. No payments can trickle down the waterfall until scheduled (or overdue) interest or principal on the prevailing senior ranking claim is paid.
- For simplicity, each credit rating category is shown to have only one tranche.



6. Simplified CDO contractual waterfall



7. Assessment of Prevailing Securitization Conditions (from 0 to 5)

	Sale, assignment or other conveyance of assets to securitization vehicles			Creation and operation of SPV		Other	
	Legal framework for creating, transferring and perfecting ownership interests	Restrictions on types or terms of financial assets that may be transferred	Taxation and capital gain recognition issues by the SPV	Default, foreclosure, repossession at the level of source individual assets	Legal and regulatory impediments (e.g.: bankruptcy remoteness)	Taxation or licensing requirements	Restrictions on securitization vehicles issuing multiple tranches
Hong Kong, China	5	5	4	5	5	5	5
Indonesia	2	2	2	2	1	2	2
Korea, Rep. of	5	4	3/4	4	5	5	5
Malaysia	5	4	4	3/4	4	4	5
Philippines	2/3	2/3	1/2	2/3	2/3	1/2	2/3
Singapore	5	5	5	4	5	5	5
Thailand	3/4	3	3/4	3/4	2/3	4/5	2/3

8. National enabling legislation and regulation

People's Rep. of China	Major bank sector securitization legislation under preparation 2007-08. Limited trial deals permitted by banking and securities regulators in 2006-07
Hong Kong, China	Permissive legal framework, except for conflicts with bankruptcy laws arising in certain future flow transactions
Indonesia	Pre-1997 securitization decrees 2002-03 securities regulator guidelines
Japan	Perfection Law 1998 Asset Liquidation Law 1998/2000 Trust Business Law (Amendment) 2004
Rep. of Korea	1998 Asset-backed Securities Law 1999 Mortgage-backed Securities Law 2003 Korea Housing Finance Corporation Law
Malaysia	Generally permissive common law legal framework, except for future flow transactions. Well-established legal framework for Islamic securitized issues.
Philippines	2002 Special Purpose Vehicle Act, Republic Act No. 9182, enacted 2003 2004 Securitization Act, Republic Act No. 9567 (largely untested) Implementing Rules and Regulations (2005) over credit rating requirements and the use of SPVs.
Singapore	Permissive legal framework, except for conflicts with bankruptcy laws arising in certain future flow transactions Highly supportive REIT regulatory code 2001-05, Business Trust Act 2004
Thailand	1997 securitization decree 2003 Asset-backed Securitization Act 2004 Special Purpose Vehicle Act
Viet Nam	None
