CAPITAL MARKETS — FUTURE DIRECTIONS IN SECURITISATION

Securitisation as Evolution "A Fish Tale"

NANCY FOX

AIDC Ltd, Sydney

Once upon a time, there was a fish. The fish had a great old time: swimming around, hanging off the beach, spawning at full moon. Then one day (about 300 million years ago), this fish grew legs and lungs, and walked out of the ocean onto dry land. It was quite a shock, but at least the fish knew when evolution hit him.

In the world of finance, evolution takes place just as surely as it does in the world of fish. Banks and financial institutions, corporates and governments - with securitisation they are taking an evolutionary step. But unlike that fish, they are not necessarily aware that things have changed.

This paper discusses what happens when securitisation takes place. More to the point, this paper discusses what securitisation does to the parties involved - the securitisers, the lenders, and the providers of financial services and facilities. Even more to the point, this paper discusses how securitisation requires these parties to play different roles and how those roles will change in the future - roles in which they are being coached by you, their counsel.

I. THE BASICS - TRADITIONAL LENDING VERSUS SECURITISATION

Back in the Palaeozoic Era, a single institution - most often a bank - would originate a loan, negotiate its terms, assume the credit risk, provide the funds, and make collections until the loan was repaid. The bank made good money, as long as it picked its credits wisely, as long as it charged more on the loan than it paid on deposits, and as long as its capital held out. The bank made good money, for a fish.

But the banks aren't fish any more. A bank is now subject to capital adequacy guidelines. And once these guidelines took effect, the bank was no longer satisfied with the spreads earned on traditional lending. Instead, the bank seeks the fees that can be earned on swaps, derivatives, and other products which generate a much higher return on allocated capital. In this new atmosphere, the banks are looking to securitisation.

Allow me to begin with a basic definition of securitisation: Securitisation can be defined as a cash flow in a bullet-proof vehicle with sufficient structural enhancements so as to constitute an attractive investment. The cash flows are principally repayment streams, on assets ranging from mortgage loans to credit card balances to short-term trade receivables. The bullet-proof vehicle is most often a trust, but can also be a special-purpose corporation; its purpose is to hold the cash flows for the benefit of investors. The structural enhancements include credit enhancement in any of its many forms, as well as liquidity facilities, swaps, and guaranteed investment contracts.

In the context of a securitisation, there is the originator, who creates the cash flow, by signing up the mortgagor, extending the personal loan, or selling widgets on 90-day terms. The cash flows are owned by the trustee or the special-purpose corporation, often after having purchased the cash flows from the originator. The cash flows are administered by a servicer, often the originator itself. Structural enhancements include just about every product a bank can offer - every product, that is, except a plain old-fashioned loan. And once all this effort has gone into creating an attractive investment, an underwriter steps in to distribute the securities to investors. Quite a change from the old days, when a single fish did it all.

II. EVOLUTION - CHANGING ROLES

"So what?", you might ask. Someone has to originate the assets. Someone has to collect payments. Someone has to come up with the funding and wear the credit risk. **So what** if it used to be a single party doing it all, and now there are many. If the cash flows and the responsibilities related to those cash flows have not changed, what has?

Allocating responsibilities among many parties might not create any new responsibilities - at least not with respect to the cash flows. But allocating responsibilities definitely creates new relationships, and with those relationships come new responsibilities. Nowhere is this more clear than in the change in roles from lender to securitiser.

From lender to securitiser - a new accountability

For convenience, allow me to couch this paper in terms of a bank which elects to securitise its assets. The same principles apply to a non-bank financial institution or an industrial, but it is the case of a bank which presents the most vivid example. When a bank changes from a lender to a securitiser, accountability comes to the fore. Banks are currently accountable to their shareholders and their depositors.

With respect to a vast majority of shareholders - at least by number - accountability means an annual report, and maybe an interim statement or two. Let us assume that every shareholder looks at all the pictures in the annual report. Let us assume further that every shareholder reads the Chairman's and Managing Director's reports. Further still, that every shareholder pores over the balance sheet and income statement. And of course, because "*the accompanying Notes form an integral part of the Financial Statements*", that every shareholder is familiar with the fine print in *Note 16.*

Without commenting on the reasonableness of these assumptions, the financial statements in an annual report (complete with accompanying notes), as complex as they are, are not nearly complex enough. They might present a full and fair view of how the bank as a whole is performing, but they simply do not give enough information to allow a shareholder to form an opinion about any one of the many businesses that make up a bank. As an external control, the shareholder is effective only on the bottomest of bottom lines.

The depositor can place the most exacting demands on a bank: She knows to the penny how much interest should be credited to her account. But in this regard, she is behaving more as a customer than as a stakeholder in any larger sense. As an external control, the depositor should be thinking of the big picture: whether the bank can make good on the deposits which it is privileged to take.

Enter the depositor's alter ego: the regulators - here, the Reserve Bank of Australia - dedicated to overseeing the soundness of the banking system for the protection of depositors. External controls? There are plenty, including margin requirements, prime asset ratios, and of course capital adequacy. But in a way, these regulatory measures bear a similarity to the typical annual report. They are applied not with a sophistication comparable to the sophistication of the underlying business of banking, but only at a bottom-line level. For example, a loan to BHP is risk-weighted the same as a personal loan to me - scarcely a sophisticated approach to the different credit exposures which BHP and I represent.

This is not to say that banks do not have plenty of internal controls: risk policies and procedures, credit committees, internal and independent audits - the list goes on. But even in the most rigidly controlled environment, a broken rule is an internal affair: fixing the problem, punishing or excusing the party responsible, or even ignoring the problem, all are done within the bank's four walls.

What securitisation does is **externalise** the internal controls. With respect to a specific portion of the bank's business - that portion which is being securitised - the bank is no longer accountable only to its shareholders and depositors/regulators. As well, the bank becomes accountable to a discrete group of investors and their alter egos - the trustees and facility providers which help define the deal.

The three sections below go into greater detail as to how securitisation imposes a new set of external controls on three key areas: operations, disclosure, and pricing. But it is important to note that these controls entail more than a few changes to procedure. Instead, they require a whole new attitude - a different way of approaching the transaction which you, as their counsel, can help them adopt.

Operations

If a bank makes an error in sending a notice, coding a mortgage repayment, or confirming information in a mortgage application, it is the bank's problem. As and when the mistake is discovered, it is corrected. In the context of securitisation, however, a mistake is more than a mistake. A mistake is a breach of contract - an act of the bank itself and not just an error committed by an individual employee. As with any breach of contract, the breaching party comes under enormous pressure to rectify the breach. But rectifying a breach, even if it is considered typical of a contractual relationship of this sort, smacks of "moral recourse". (Moral recourse is the concept that a bank is going to go beyond its strict legal duty to prevent an investor from suffering a loss which it has contractually assumed - one of the RBA's great concerns.) As a result, it will not be good enough for a bank to make errors in the ordinary course of business, even if the errors can be rectified with little cost after the fact. Instead, the bank must strive for total compliance, for it will be living life under a microscope.

In the case of an industrial, the widget-maker who securitises its trade receivables, the concern is not so much small mistakes in the ordinary course of business. Instead, the concern relates to discretionary acts. It is the rare manufacturer who does not extend payment terms to a good customer, offer a rebate to a disgruntled customer, or negotiates a partial payment from a customer going broke - in all cases, the manufacturer settles for less than what is owed. But if the manufacturer no longer owns what is owed, the manufacturer no longer has the unfettered right to settle for less.

Disclosure

As noted above, a bank's annual report might give a **shareholder** a full and fair view of how the bank is performing as a whole, but it provides only the scarcest of detail on a business-by-business basis. When a bank securitises its portfolio of credit card receivables, however, the investor in the securities could not care less about the performance of the bank as a whole. Instead, the investor wants to know (and the bank is obliged to tell) exactly how the bank's credit card receivables have performed in the past. Now apply this new standard of disclosure to the mortgage loan portfolio, and to home equity loans, and to personal loans, and to every pool of assets which conceivably could be securitised. Soon, there are no more secrets, no more divisions whose performance - good or bad - is hidden in aggregate data.

Pricing

In theory, a bank should price a product based on the true cost of delivering the product, where the cost reflects administration, loss reserves and, of course, the cost of funds. But what is the true cost of administering a single mortgage loan entered on the bank's multi-million dollar computer system? Is it the incremental cost (practically zero), or a figure which reflects the high cost of computers back when the system was purchased? And what is the true cost of funds? Should it reflect a bank's low-interest deposit base, or the interbank rate? Again, a bank should price a product based on the true cost of delivering the product. And the true cost of delivering a product? In practice, it is whatever the bank wants it to be.

Not so with securitisation. Every securitisation deal must stand on its own. The assets must earn more than the securities into which they are transmutated. The cost of a swap, the cost of bridging a delay in cash flows, the cost of reinvesting idle funds - a securitisation structure is transparent, and all of these component costs become visible. The rating agencies even set a minimum allowance to cover the costs of servicing, which must be incorporated into the deal to ensure there is enough in the deal to pay a substitute servicer (if needed).

In effect, securitisation creates an unbreakable link between securitised assets and the capital markets. The freedom in pricing once enjoyed by the banks is replaced by the required margins on the assets once they are securitised.

All of the above illustrate how splitting responsibilities creates new relationships, which in turn create new responsibilities. At the same time, allocating responsibilities among parties creates new obligations - the contractual obligations which accompany each party's role, as well as the statutory obligations which attach. (In that I am not admitted to practice in Australia, though, I will limit my comments below to contractual considerations.)

From lender to facility or service provider - new constraints

Once again, allow me to use the convenient example of a bank. Whether the bank is securitising its own assets, or whether it is providing securitisation services to a client who would otherwise be a borrower, the bank is acting in a limited role only. Its role can be limited to providing credit enhancement or a liquidity facility, or it can be limited to underwriting the securities. And when it is acting in a limited role, it must recognise and respect those limits.

When a bank lends money against a pool of assets, it earns a spread on the entire pool balance. The spread includes an allowance which, if the bank recovers, say, 99 cents on the dollar, buffers the loss - at least in theory. But if that same bank provides a 5% letter of credit, and loses 1 cent on the dollar, there is no conceivable way that the fee on the letter of credit can compensate for a 20% loss - or, typically, for losses of any amount. In other words, when the bank writes credit enhancement, as opposed to writing loans, portfolio losses cannot merely be kept to acceptable levels. Instead, the bank must write its business to a no-loss standard.

The curious might ask where the credit losses go. In the standard Australian mortgage backed deal, primary mortgage insurance provides first-loss protection. In the standard trade receivables deal, credit losses are covered by a reserve or holdback, whereby the originator is paid only a portion of the nominal amount of the securitised receivables. In other types of deals elsewhere in the world, there can be spread accounts, where a portion of the interest earned on the securitised assets is used to fund a reserve, or subordinated interests retained by the originator. All of these structural devices are used to absorb losses before the credit enhancer sustains a loss.

If a credit enhancer is risk averse, a liquidity provider is even more so. And with good reason, as liquidity providers earn fees much too lean even to **consider** losses. (The purpose of a liquidity facility is to provide funds, in the nature of a short-term loan, to cover timing mismatches. A liquidity facility is not intended, however, to cover credit losses or structural shortcomings. In some cases, the liquidity provider is required to purchase the assets underlying a securitisation. To protect the liquidity provider in these cases, either the credit enhancement must follow the assets, or the assets must be of such a high creditworthiness that they need no enhancement, *ie*, government bonds.)

The constraints on an underwriter are more subtle. Let us use the term "underwriting" in its formal sense: Underwriting is the purchase of securities with a view to resell. (The term is sometimes misused, to describe a standby purchase facility if short-term securities cannot be rolled over - a facility much more akin to a liquidity facility.)

Both a lender and an underwriter must be comfortable with the credit of a loan or the securities, as the case may be. An underwriter, however, has no intention to hold the securities it purchases. The underwriter is compensated for its distribution capabilities: It earns its fees by **selling** the securities - the faster the better. A lender, on the other hand, is compensated for its balance sheet: It earns its income from the act of **holding** the loan over its entire life.

At the same time, underwriting has its own risks, different from those of lending. Regardless of the strength of an underwriter's balance sheet or its ability to select prudent investments, it is subject to market risk. An underwriter does not have the luxury of waiting until the securities eventually are repaid. Instead, it always must seek to sell its inventory, even if it does so at a loss. Although the underwriting fee includes a premium for this risk - at least in theory - an underwriter's best insurance is a sure knowledge of the market and quick execution.

Just as securitisation requires the lender-turned-securitiser to conform to a new standard of accountability, securitisation requires the lender-turned-provider to identify the risks relating to its new role, and to avoid those risks inconsistent with the pricing of the facility or service. As counsel to these parties, you need to be aware of these risks and advise your clients accordingly. Welcome to dry land!

III. WELCOME TO DRY LAND?

You may be wondering why anyone would securitise in the first place. After all, the decision to securitise brings new and different responsibilities, new and different risks. Maybe it was not so bad swimming around, hanging off the beach, spawning at full moon. But this is like saying that, as soon as that fish learned to walk, it developed bunions, so why bother.

The very point of securitisation is that it involves a new and different set of responsibilities, a new and different risk profile. "New and different" means not only that certain responsibilities and risks are assumed, but also that certain responsibilities and risks are transferred. Granted, a securitiser takes on a higher standard of disclosure and a stricter duty of care with respect to securitised assets. But a securitiser also sheds the requirement that it fund those assets, and that it raise and/or maintain the capital necessary to support that activity. (I would also suggest that, with the responsibilities of a higher standard of disclosure and a stricter duty of care, comes a greater discipline - a benefit in its own right.) Granted, a credit or liquidity facility provider can be punished more harshly for its errors in judgement. And granted, an underwriter must learn to live with market risk, a risk to which most lenders have previously been impervious. But the provider of facilities and services also earns fee income and enjoys enhanced performance measures such as return on equity. If dry land means bunions, it also means skipping and dancing.

A final word of advice to those of you who are counselling prospective securitisers. Your clients are no longer fish, and you share the responsibility of making them understand that fact. And a final word of caution to those clients out there who choose to ignore securitisation and what it means to the competitive environment: Evolution did not stop once that first fish took a stroll on dry land. That fish's grandchildren invented first the boat, and then the fishhook.