



Securitization Pricing in a Post-Crisis Market

Policy-makers seek to make the securitization market more resilient and sustainable, preventing the excesses that were able to pop up in certain segments of the securitization market, but they do not seek the closure of securitization market

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Whilst the crisis in the global securitization market started in 2007 and quickly reached its low-point in terms of market issuance and investor reception in 2008-2009, the recovery has been very slow. Leveraged investors have abandoned the market significantly (as intended by policy-makers) but many end-investors too have decided to end their investment programs in securitization. This latter trend can be seen as a mostly unintended effect: after all, most policy-makers and regulators believe that securitizations have an important role to play in financing the real economies, be it mortgages, small-business loans, consumer loans or auto

loans and leases. Indeed policy-makers seek to make the securitization market more resilient and sustainable, preventing the excesses that were able to pop up in certain segments of the securitization market, but they do not seek the closure of securitization market.

The global policy consensus seems to be that provided that securitization is “simple, transparent and standardized”, it can be a valuable way of attracting funding to the economy from institutional investors, alongside the traditional banking sector. In fact, one can argue that in a post-crisis world, banks themselves will find it beneficial to be able to offer loans to customers in the knowledge that

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they will be able, at some point either immediately or somewhere during the life of the loans, to offload part of the capital and/or risk associated with the loans to third parties. It gives their otherwise largely illiquid lending businesses a liquidity profile that cannot be achieved without some form of packaging into a tradable instrument, i.e., securitization (Nawas&Vink 2013). “Simple, transparent and standardized” are for exactly that reason the core themes in the European Commission’s current proposals to regulate the European securitization market in the context of the European Union’s Capital Markets Union initiative (see European Commission 2015, and the recent joint market responses AFME et.al. 2016 and PCS et.al. 2016 in which the concepts of simple, transparent and standardized are broadly embraced, albeit with calls for further specificity and clarification).

Next to the increases in regulations and capital requirements for investors in securitizations, another important reason for the lackluster nature of the recovery of the securitization market is external to the securitization market: the huge quantitative easing that central banks, such as the US Fed, the ECB and the Bank of England have put in place to stimulate the economy. The effect has been that banks have been flooded with liquidity, interest rates have dropped and therefore the cost of providing liquidity to customers by banks has become so low that it has undone the incentive for these banks to seek liquidity elsewhere in the form of securitization. A lack of supply is therefore the current main impediment to restoring the growth of the securitization market, more so than a lack of investor demand.

It is impossible to predict when the securitization market will re-emerge as a major source of liquidity. This could occur once the market believes that it has reached the final stages of the global regulatory response to the 2007-2008 securitization market disruptions and therefore the regulatory environment has become stable. Alternatively, a re-emergence of securitization could be prompted by the



paring back of the quantitative easing programs, when banks begin to experience a rising costs of liquidity. In any event, at some point the market will begin to grow again, and supply and demand will re-find equilibrium. Therefore it is important to ask ourselves the question: what would equilibrium prices look like and what would determine them? To approach this question, we look back at the empirical analysis conducted in part at our faculty on the basis of pre-crisis non-US securitization market data, where we compared and contrasted the common pricing factors in MBS, ABS and CDOs (Thibeault&Vink 2008).

Data

By applying appropriate filters to a main sample of non-US securitizations (predominantly Eurozone and UK securitizations, but also including lesser amounts issuances from Asia and Australia) from January 1999 to March 2005, Thibeault&Vink had derived a so-called “high-information sample” of 3,467 securitization tranches (worth €548.85 billion) of which 1,102 (worth €163.90 billion) have been classified as ABS, 1,783 (worth €320.83 billion) as

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MBS and 582 as CDO tranches (worth €64.12 billion).

The high-information sample included information about three types of characteristics: default & recovery risks, marketability and systemic risks. Default & recovery risks were compared based on credit rating, maturity and credit enhancement. Marketability characteristics on size of the tranche, size of transaction, number of tranches, number of lead managers, number of credit rating agencies, whether the issue is retained or not, and floating versus fixed interest rate. And one systemic risk characteristic was examined: currency risk. A comparison between the common

variables in the full sample and the high-information sample revealed sufficient similarity in terms of loan spread and the characteristics listed above to plausibly assume that any empirical results derived from the high-information sample can be generalized to the larger population including all issues.

Univariate analysis

When analyzing the pre-crisis data with an initial focus the pricing, it becomes clear that average (median) spreads were statistically significantly lower for MBS, with 73.9 basis points (45.0 basis points) than they are for ABS, with 99.2 basis points (50.0 basis points), and CDOs, with 162.4 basis points (95.0 basis points). Furthermore, CDOs were more than twice as likely to have currency risk involved compared with MBS (39.8% versus 15.9%), and even more than three times compared with ABS (39.8% versus 13.3%).

MBS and ABS on average tended to be less risky than their CDO counterparts, which were confirmed by the credit rating class. Since credit rating and spread tend to have an inverse relationship, it is unsurprising that the average credit rating class for MBS (4.0) and for ABS (3.9) was significantly lower than the credit rating for CDOs (4.6). ¹The number of rating agencies and the number of managers

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involved also provide (indirect) evidence of the riskiness of the loan — or at least an indication of the difficulty to underwrite the issue. The average number (median) of participating lead managers for MBS is 1.6 (1) and was significantly larger than the average of 1.4 (1) for ABS and 1.2 (1) for CDOs. MBS had an average of 4.1 (median 4.0) rating agencies involved, significantly higher than the 3.8 (3.0) agencies for ABS and 3.7 (3.0) agencies for CDOs.

The MBS class exhibited the largest average (median) transaction size of €800.0 million (€600.5 million) followed by CDO and ABS with an average (median) transaction size of €616.1 million (€358.8 million) and €475.1 million (€331.4 million) respectively. MBS also exhibited

the largest average (median) loan tranche size, amounting to €209.6 million (€48.2 million): an average €82.4 million more than the average tranche size exhibited by CDOs, and €59.3 million more than the average loan tranche size exhibited by ABS. All are significantly different.

An MBS tranche of average size had a relatively long legal maturity, just over 27.5 years, long compared with the average 11.3 and 15.1 years for ABS and CDO respectively.

Finally, ABS tranches were almost four times more likely to be fixed rate than MBS (41.4% versus 13.7%), and almost twice as likely to be fixed rate compared to CDOs (41.4% versus 26.1%). Locking in a specific rate, in general, eliminates a major source of cash flow uncertainty for the investor. So this result is notable, because one would have expected MBS to have a relatively higher percentage of fixed-rate issues since MBS report the highest average maturity (27.5 years).

Conclusion

From the pre-crisis data analysis we can see that the common pricing factors among the main classes of securitizations did differ significantly in value. On the whole,

¹Thibault & Vink (2008) mapped the long term credit rating grids of the three main credit rating agencies S&P, Moody's and Fitch to a numeric system, notch by notch with 1 representing triple A, 3 representing double A, 6 representing single A and so forth to 21 representing the lowest rating class, single D. The numeric grid facilitated the parametric testing.



both MBS and ABS had a significantly lower spread, a significantly higher credit rating and a significantly lower currency risk in comparison with CDOs. This tied in to the observation that, based on the applied measurements, ABS and MBS on average tended to be less risky than CDO tranches. MBS stood out in a number of other factors too: they were significantly larger in overall transaction size and also in tranche sizes, longer in maturity and significantly more floating rate than fixed rate in comparison ABS and CDOs. The latter is somewhat counter-intuitive, as the long maturity of the MBS tranches would likely give rise to investors wishing to reduce their cashflow risk more than for less longer dated investments such as in ABS and CDOs.

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Are these pricing factors likely to be the same in the post-crisis securitization market, once it begins to shrug off its impediments to growth and re-attract sufficient supply and demand? That is yet to be seen. CDOs as an asset class are not likely to re-appear in substantially the same way as they did pre-crisis, given their exclusion from the definition of the “simple, transparent and standardized” securitizations that are intended to form the mainstay of the market of the future. ABS and MBS will remain, and many of the univariate differences observed in the pre-crisis data are likely to apply once supply and demand become sufficiently large and diversified to re-establish equilibrium. Looking for example at the European Commission’s proposals, the credit and marketability characteristics of these asset classes do not appear to have

been impacted asymmetrically by the regulatory changes.

So investors considering whether to re-engage with the securitization market would be well-served to consider their asset class allocation from the

starting point that there will indeed remain significant value differences between the pricing factors of these two main asset classes, as will the spread differences and the other differences described above. **SA**

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