Securitization: State of The Market (up to Q1, 2014)

Shambo Dey
shambo@vinodkothari.com

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Like most forms of financial innovation, there are cost and benefits associated with the securitization of cash flows. From a conceptual perspective, a sound and efficient market for securitization can be supportive of the financial system and broader economy in various ways such as lowering funding costs and improving the capital utilization of financial institutions-benefits which may be passed onto borrowers; helping issuers and investors diversify risk; and transforming pools of illiquid assets into tradable securities, thus stimulating the flow of credit— an issue of particular relevance for some European countries. However, these features need to be weighed against the potential costs, including the risk that securitization contributes to excessive credit growth in and outside of the formal banking system; principal-agent problems that amplify perverse incentives; the complexity and opaqueness of certain products which make efficient pricing problematic; and the heavy reliance of the industry on credit ratings.

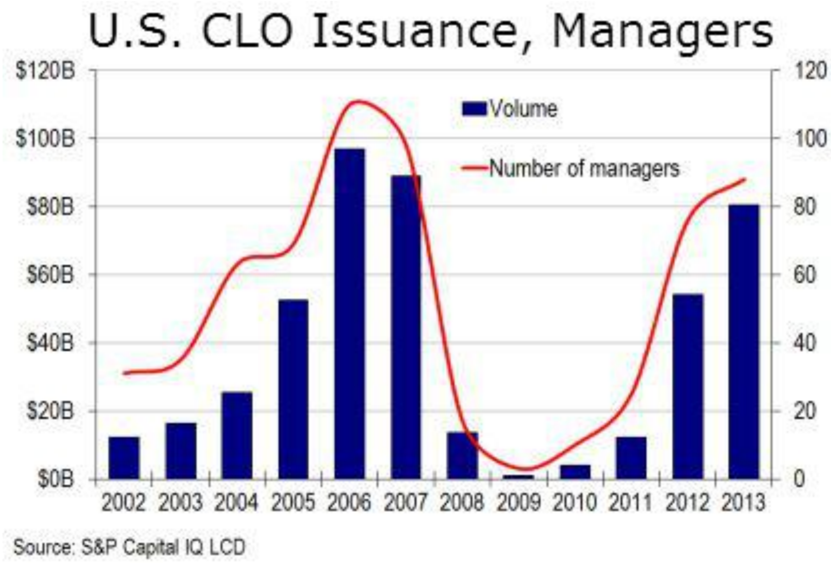
Though certain parts of the securitization market undoubtedly played a role in the Global Financial Crisis, it is also important to point out, however, that this was not endemic to all securitization markets. As the widely varying performance of securitized assets before, during, and after the crisis demonstrates, it would be misleading to discuss the market for securitization as a single, homogenous asset class. This report covers the state of the market for CLO, CMBS, Prime Mortgages and Exotic securities.

Collateralized Loan Obligations

The U.S. CLO market posted an impressive $81.81 billion in issuance during 2013, the most since the pre-Lehman heyday of 2006 and 2007, according to S&P Capital IQ/LCD.[1] Indeed, CLO issuance in 2013 beat even the most enthusiastic predictions, with 91 individual managers inking new deals during the year, up dramatically from issuance of $54 billion via 76 managers in 2012.

After a lull midway through the year issuance resumed its torrid pace in November, before cooling somewhat during the holiday-shortened December (though there was a rush of deals at year-end).

[1] http://www.forbes.com/sites/spleverage/2014/01/02/2013-clo-issuance-hits-81-9b-most-since-2007/



Source: S&P Capital IQ LCD[2]

The market has witnessed the rising trend among US insurance companies who are increasing their exposure to collateralised loan obligations (CLOs), as banks have started retreating from the market in the wake of new regulations. Insurers have been lured by widening spreads on CLO tranches since the end of last year, as demand from banks has plunged amid concerns that investments in some structured securities will be disallowed under the US Volcker rule, which bans proprietary trading. Spreads have increased by as much as 15 basis points. Default and loss rates, on the other hand, have been either insignificant or lower than similarly rated securities or corporates over the past two decades.[3]

Europe

The new generation of European CLOs is leaning heavily on the primary loans market. The market for collateralized loan obligations in Europe is heading for the busiest start since 2008 amid signs that issuers may be able to overcome new regulations such as the Volcker Rule that are crimping U.S. deals packaging junk-rated buyout debt. At least 2.4 billion euros ($3.3 billion) of the securities have been sold or are being marketed, more than four times the same period last year.[4] Before the financial crisis, CLOs were the biggest investors in European leveraged loans and their appetite for the debt encouraged private equity firms to raise record sums to fund buyouts. As the region's economy emerges from a record-long recession,

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[2] http://www.forbes.com/sites/spleverage/2014/01/02/2013-clo-issuance-hits-81-9b-most-since-2007/

[3] S&P Ratings Annual Report, http://www.risk.net/insurance-risk/news/2333008/us-insurers-tap-clo-market-as-banks-retreat

[4] Bloomberg News, http://www.bloomberg.com/news/2014-02-17/clo-sales-climb-in-europe-as-volcker-sidestepped-credit-markets.html

expanding 0.3 percent in the final quarter of 2013, the new regulations are raising concern that the market for CLOs will wilt, cutting off financing to borrowers that may otherwise not have access to capital.

Asia

Asian investors are taking a lead role: the yield pick-up on a CLO versus US Treasuries is proving attractive for north Asian investors – particularly insurers that are struggling with high guarantees on their historic business. In the CLO market broadly, US investors are the dominant participants, but Asian investors would be the next largest group led by Japan.

Asian investors, particularly Korean insurers, are beginning to participate in the market more recently which is consistent with what large, sophisticated US insurance companies and money managers are doing. However Korean insurers are looking at the investment grade CLO mezzanine market as opposed to AAA.

The resurgence in CLO issuance and the appetite for it from Asian investors is notable given the role that structured credit played in the subprime crisis and the subsequent collapse of Lehman Brothers. Asian investors are cash rich and looking for yield given the continuing low interest rate environment in the region and thus have been buyers of CLOs. In terms of Asian flow what we have seen is more insurance companies buying senior tranches because of attractiveness in returns.
Banks in Asia have also been buying US CLOs, the majority of which are rated AAA as the regulatory treatment is relatively low in terms of capital charges. There are very few Asian CLOs as banks do not have the need to issue these types of products given that they are relatively well capitalised and funded. Also the CLO model in Asia is different from the US. In Asia, the bank would be the originator and seller of CLOs versus the US model where you have multiple CLO managers who buy these loans from banks to sell to investors. In Asia, banks simply do not see a need to issue CLOs.

Commercial Mortgage-backed Securities

New regulatory restrictions on traditional lenders-—including Basel III and Dodd-Frank—could open the way for private equity and hedge funds, as well as start-up lending shops, to fill some of the void or step in to resuscitate the still-flagging conduit business. Sputtering to life from a shadow of what it was, CMBS seems to have a chance to lurch back into the financing spotlight once transaction activity increases. The risk spread on 3 and 5 year AAA rated CMBS in Europe and US have

shown steady declines whereas spread on 3 and 5 year BBB rated CMBS in US have remained high but for similar securities in Europe, the spreads have fallen.[5]
The CMBS delinquency percentage has shown a consistent decline from a high of 8.5% since May 2012 to the current 4.96% level in February 2014. Current percentage levels equate to those seen in late 2009 (5.22% delinquent in December 2009).[6] The delinquent unpaid balance for CMBS may continue to be impacted by the size and amount of loan liquidations, modifications, extensions and resolutions reported on a monthly basis, and are clearly on a road to recovery. These items, along with continued new issuance growth, should lead to a further decline in delinquency levels in 2014.

In 2013, the U.S. CMBS market saw approximately $86 billion in new originations, according to Mortgage Banker's Association research. In 2014 that figure may likely go up to $100 billion.[7] The low interest rate environment and favourable monetary policy have been driving up competition in the CMBS space, with conduit shops getting more aggressive on new loans. Data further shows that in the fourth quarter of last year originations on CMBS loans rose 35 percent compared to the quarter prior.[8]

The good news is that at $100 billion the CMBS market could still be considered healthy and not over-heated. That would make CMBS lenders responsible for approximately one-third of all commercial mortgage originations, giving them about the same amount of market share as banks and life insurance companies. At the peak of the market, in 2007, U.S. CMBS volume was moving toward $230 billion. Over the course of 2013, banks increased their holdings of commercial and multifamily mortgages by seven percent, and their balance of just multifamily mortgages by more than 12 percent. Commercial mortgage-backed securities' holdings increased for the first time since 2007. Life insurance companies, the GSEs and FHA each have increased holdings (or guarantees).[9]

The steady increase in CMBS lending volume has reassured industry members that there will be money available to refinance most of the loans scheduled for maturity in the years 2015 through 2018. When coupled with the steady increase in property values, those loans will likely not become a huge issue for the commercial real estate industry.

[5] AFME Securitisation Data Report Q3, 2013, http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=10062
[6] Report by Morningstar Rating Agency, http://www.slcapmarkets.com/announcement.php
[7] MBA Convention and Expo, Orlando February 3, 2014
[8] Id.
[9] CREF Outlook Survey, http://www.mbaa.org/NewsandMedia/PressCenter/87567.htm

The bigger concern at the moment is not the volume of originations, but the fear that, in an effort to beat out competition, conduit shops are going to get too aggressive on underwriting, essentially creating conditions for another bubble.[10] In 2013, underwriting terms on CMBS loans stayed fairly conservative. Still, the average loan to value (LTV) ratio on CMBS loans has risen to 67 percent from 63 percent.[11] For the moment, that's still a far cry from 2007 underwriting standards (or lack thereof), when interest only loans with LTV ratios of 75 percent and above made up the majority of CMBS deals.

Fitch Ratings indicate that several signs point toward an improved CMBS market. In a third-quarter report on special servicing on commercial mortgage-backed securities, the agency said the recovery rate for liquidated loans climbed to 75% from 61% in the previous quarter.

Other positive trends:

- Special servicing volume decreased to $52 billion at the end of the third quarter, accounting for 8% for all CMBS loans. That figure had peaked at 12% in 2010.
- Only $2.2 billion in CMBS loans were transferred into special servicing, the lowest figure since 2008, and a fraction of the $7.7 billion that were transferred out. The decrease in transfers into special servicing continued a trend dating back six quarters.
- The average balance of CMBS loans modified during the third quarter was $17 million, the lowest figure since Fitch began tracking data. In contrast, the average balance in 2012 was $33.8 million.[12]

The market certainly seems to be in a different position this go around, with increased transparency and higher credit support levels, and perhaps most importantly, more vigilance on the part of investors.

Europe

The year 2013-14 has signalled the effective re-opening of the European CMBS market, after a trickle of one-off deals in 2011 and 2012 which never quite built up a momentum. This recovery has been driven by increasing risk appetite, improvements in the macro economies of Europe and the normalising of bank lending. There are also fewer 'mispriced' assets in the market now and investors looking for higher returns may have to accept higher credit risk or lower liquidity. In

[10] https://www.krollbondratings.com/show_report/1053
[11] Id.
[12] Fitch Surveillance Report 2014, http://www.slcapmarkets.com/announcement.php

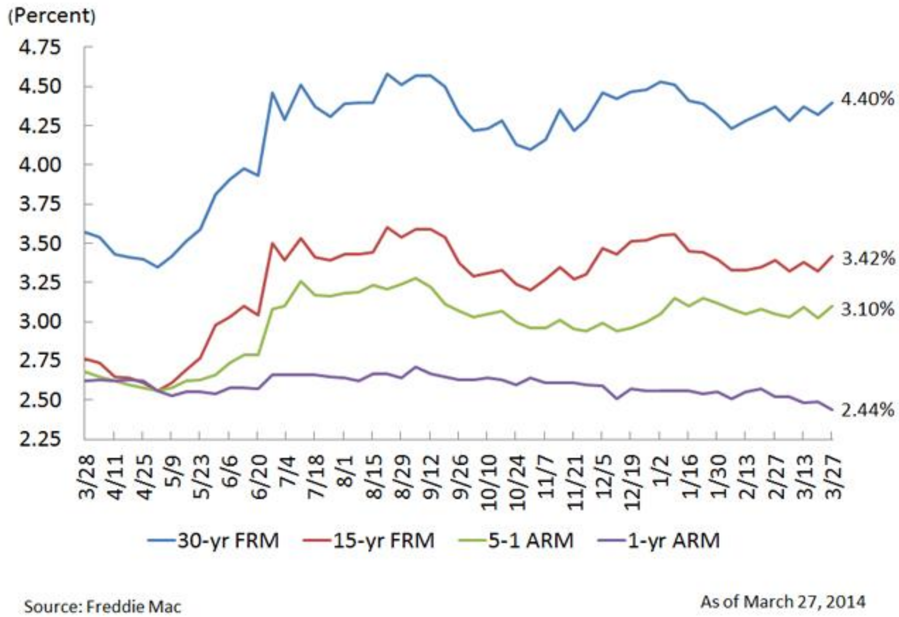
2014, it is highly likely that investors will focus their attention to new issuances rather than to secondary trading.

Prime Residential Mortgages

More than seven years after the subprime bubble began to deflate, lenders and borrowers have begun operating under a new set of rules. From the onset of 2014 these regulations have taken direct aim at boom-era lending habits that allowed borrowers to take on more debt than they could handle, with disastrous consequences for homeowners, lenders, and the broader economy. The highlight is that a modicum of logic will become standard: Lenders will no longer be allowed to sell a mortgage that a borrower can't reasonably repay.

The 2010 Dodd-Frank financial overhaul law called for the newly created Consumer Financial Protection Bureau to write the rules, which will require lenders to evaluate whether a loan is affordable. As commonsensical as that sounds, it was optional in the past. After more than two years of comments, lobbying, and drafting, the bureau released its final regulations in early 2013. Lenders must now verify and document at least eight specific criteria, including income, assets, credit history, other debt obligations, and employment status, to determine whether a borrower has a reasonable chance of repaying the loan. If the lender doesn't do all that, a homeowner who has trouble repaying the loan has grounds for a lawsuit.

In the prime lending market, rates for most mortgages have soared, except for 1-year mortgages whose rate has virtually remained flat.



Source: Freddie Mac[13]

Exotic Securitizations

On end of the spectrum of exotic securitisations is solar securitisation. At the end of November 2013, SolarCity issued the first publicly known solar asset-backed securitization (ABS), selling $54 million of bundled cash payments. It was a major milestone that many in the distributed solar industry have eagerly awaited. ABS provides a mainstream public capital market investment opportunity for distributed solar projects. And it provides lower cost of capital, thus improving solar monthly contract (PPA or lease) competeviness with utility rates. In other words, securitization makes solar cheaper than the utility bill for more new customers more often. But while this offering is an important step in the right direction, several things need to happen before this type of financing is sufficiently consistent and widespread for it to trickle through to savings on customer financing rates. One reason why solar ABS can scale is because solar securitisations are increasingly incorporating standardized terms, minimum quality standards, assessing credit risk and ensuring construction quality, to take the next steps towards reliable, low-cost capital at scale.

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[13] http://www.freddiemac.com/pmms/

The other area of growing interest is climate bond. Renewable energy projects lend themselves to securitisation due to their stable income profile. Banks or other institutions could finance projects in their first few years of operation, then, after at least one year's operation, securitize them as proven and mature investments for institutional investors. In this model a fund (bond holding vehicle) would purchase portfolios of debt secured against renewable energy projects from banks. The fund would finance this purchase by selling bonds into the market. The bonds could be in the form of 15 year amortising bonds which are suitable for annuities.

The critical mass is important here. The fund must be of sufficient size that its bonds are liquid in the market and can be subsequently traded by bond investors. Going back to the first forms of securitisation, only quality senior loans would be purchased by the fund, and only a single type of bond would be sold by the fund to investors. The parameters should be transparent, predefined and regulated. This should produce a standardised quality bond for the bond-holders. The bonds produced will have similarities to energy utility bonds but could be classified as Climate Bonds as they would not be associated with funding any thermal power (coal, oil or gas). An advantage over energy utility bonds is that retail or institutional investment allocations can be made into the debt of pure renewable energy assets. The bonds could pay a coupon similar to that of the bonds of energy utilities 5% to 6%.

This type of fund is designed to transfer to long-term investors the lowest risk part of the capital structure of renewable energy assets that have a track record. It will enable banks to recycle their capital and lend new riskier development finance to facilitate the building of new renewable energy assets, and so facilitate the long term funding requirements of renewable energy asset owners. This principle could be applied to the idea of a green investment bank where the bank purchases debt and repackages it to produce bonds.

The third area that is performing well is insurance and reinsurance linked products. Sales of cat bonds topped $6 billion in 2013, the highest since 2007.[14] As investors

[14] Wall Street Journal, Oct 18, 2013 Ed.; Between the start of 2013 and the end of September 2013, "total returns on catastrophe bonds were almost 9.5%, according to a Swiss Re index. By contrast, investment-grade corporate bonds issued in euros had clocked up returns of about 1.3% over the same period, according to Markit."

increasingly come to appreciate the returns possible from insurance and reinsurance linked investments they are looking for new opportunities to invest. That is leading to an expansion of the market into new lines of reinsurance business and further pressure on traditional reinsurers balance sheets. It is expected that through 2014 issuance of cat bonds and ILS may outstrip maturing bonds.

Risk Areas to Consider

Expansionary monetary policies have driven interest rates down to historically low and sometimes negative levels in real terms. While these policies supported the functioning of the global financial system and potentially stimulate the real economy, spill-over effects may create potential risks for securities markets. Real interest rates have been low for many years in the Eurozone, the U.S., the U.K. and Japan; for many the real interest rates have been below 3%. The main exception was 2009 when rates reflected the possibility of a Eurozone break-up. Since then, real interest rates have fallen and actually became negative in some countries.

In an environment of low interest rates, securities market products offering relatively high yields have become popular. When fear in the markets evaporated after 2009, the risk appetite of investors has resulted in a search for yield.[15] Bonds with higher interest rates reflecting a higher risk premium – both sovereign and corporate – faced increasing demand. Apart from the securities that offer high yields reflecting the higher market and credit risk, the search for yield can also be noted in securities that offer high yields through leverage – and sometimes combined with higher market and credit risks. There is newfound demand for Collateralized Debt Obligations (CDOs) including Collateralized Loan Obligations (CLOs). These complex products offer higher yields by adding leverage to market or credit risk. The issuance of CDOs has risen from $6 billion in 2010 to an estimated $35 billion in 2013 being back at pre-crisis levels. Especially in the US the issuance of CDO´s has surpassed the amount in 2008. Furthermore, market intelligence suggests that demand for structured retail products with leverage and for hedge funds also has grown. Finally, inflows into Real Estate Investment Trusts (REITs) in the U.S. have surged.

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[15] Bank of England, Financial Stability Report 2013;
http://www.bankofengland.co.uk/publications/Documents/fsr/2013/fsrfull1306.pdf