



Introduction to Securitization: The Market for MBS, ABS, CMOs and CMBS

Overview

Securitization is a structured finance technique in which marketable debt securities are created from pools of cash-flow producing financial assets. The cash flows generated by the pool of underlying assets are used to make interest payments and to repay the principal of the securitized bond.

The first securitized bond was introduced in 1970 by Ginnie Mae. Prior to this, the secondary market for certain financial assets such as mortgages, leases, trade receivables and loans was relatively illiquid and fragmented. Securitization promised greater efficiencies for these markets as a way to free capital trapped in existing, illiquid mortgages or loans by selling pools of these assets to investors. The proceeds from securitization could then be used to create new loans, thereafter establishing a clear separation of roles between “originators” and “investors” — a beneficial situation for both parties. Today, securitization is used by institutions such as banks, corporations and government agencies to improve the management of their balance sheets. Investors find securitized bonds attractive for several reasons. As they

often are composed of hundreds, if not thousands, of underlying loans, securitized bonds represent well-diversified pools of credit risk. Additionally, Mortgage-Backed Securities (MBS) and Asset-Backed Securities (ABS) typically offer higher yields than comparably rated high-quality government and corporate debt.

Since its introduction in 1970, securitization bond issuance has expanded to become an asset class representing almost \$11.5 trillion¹ in outstanding debt.

Major securitized sectors

Securitized assets are classified by the type of loans supporting their cash flows.

Agency MBS are backed by residential mortgages issued through Government Sponsored Entities and represent the majority of outstanding securitized debt at \$5.6 trillion.¹ With AAA ratings, their credit risk is minimal as each individual mortgage in the pool carries an implied (Fannie Mae and Freddie Mac collateral) or full (Ginnie Mae collateral) U.S. Government guarantee.

In the late 1990s, originators began securitizing pools of non-conforming

residential mortgages (also known as Home Equity Lines of Credit, Subprime, Alt-A, Option ARMs or Jumbo). An estimated \$2.3 trillion of these Non-Agency RMBS were still outstanding as of 3/31/2010,¹ but new issuance has slowed to a trickle since the onset of the real estate correction in mid-2007.

With \$783 billion in outstandings,¹ Commercial Mortgage-Backed Securities (CMBS) represent the third largest sector and are backed by mortgages on retail, office and industrial properties.

Automobile loans, credit card receivables and student loans represent the majority of the consumer ABS sector, with \$655 billion in outstandings.¹ Other less common sub-sectors include manufactured housing, utility stranded costs, auto leases, dealer floor plans, motorcycle loans, RV loans, agricultural equipment and aircraft leases.

Also part of the securitization market is the asset-backed commercial paper (ABCP) sector, which is used to finance short-term assets such as inventories or trade receivables. The total outstandings for this sector are approximately \$400 billion.²

¹Source: SIFMA.

²Source: JP Morgan.

How do securitized bonds differ from corporate bonds?

Cash flows

Corporate debt is not typically secured by any direct claim on the assets of the issuer. Ultimate repayment of corporate debt is dependent on the issuer's future ability to generate cash from operations, divest assets, issue new debt or utilize bank lines of credit. If a corporate debt issuer were to default, repayment is then contingent on the outcome of the bankruptcy process, which can be lengthy and uncertain.

The primary mechanism for repayment of an MBS or ABS deal is the cash flows generated by the underlying pool of assets. Since an individual securitized trust could possibly contain several thousand separate loans (such as credit card ABS), repayment and credit risks are far more diversified than with a corporation. And securitized trust servicers report asset performance monthly or quarterly, allowing investors time to assess whether the risk profile of their investment remains consistent with their objectives.

Trust structure

Mortgage- and asset-backed securities are issued from a trust that is a separate legal entity from the originator(s) of the loans. The trust is a bankruptcy remote entity, meaning the securitized assets cannot be claimed by creditors should the issuer or originator go through the bankruptcy process.

For a fee, the trust employs a servicer whose responsibilities include billing, payment processing, collection services for unpaid debt and liquidation if required.

Securitized trusts can be structured as either a standalone (closed) or as a revolving (master) trust. With a standalone trust, a static pool of assets is assigned. Investors are repaid as the underlying loans mature. This is the most common securitization model.

Revolving or master trusts are actively managed. The total asset pool is kept at a constant size (net of investor debt issuance and repayments) by funding new loans with maturing ones. Credit card receivables and United Kingdom residential mortgage-backed securities (UK RMBS) follow this model.

Credit enhancement

Individual assets in each pool have the potential to experience losses. The probability of loss varies greatly by collateral type, borrower profile and economic backdrop. In addition to pool diversification, the securitization process may include additional mechanisms to minimize or redistribute actual losses:

- **Overcollateralization** is a technique where the pool of assets or loans backing an ABS deal is slightly greater than the amount of securities actually issued. This is common for auto and credit card ABS, CMBS and non-Agency RMBS.

- **Discounting** of pool receivables is a similar technique where the assets backing an ABS deal are sold into the trust at a slight discount.

- **Excess spread** is the retention by the issuing trust of some of the interest earned by the underlying assets to cover realized losses on other loans in the pool.

- **Subordination** describes the rules and processes that redirect losses away from the senior to the junior tranches.

The credit enhancement techniques listed above are intended to provide additional protection for the ABS investor and typically result in a higher credit rating. In addition, third-party insurance can provide further credit protection:

- **Loan level insurance** covers defaults by specific loans. This is a common technique used in Agency MBS and Australian RMBS.

- **Insurance wraps** can be put in place in the event that collateral losses exceed the credit enhancement. The wrap provider is obligated to cover the interest or principal shortfall in this event.

Sequential and subordinate tranching

Pass-through securities distribute the cash flows generated by the collateral directly to the investors; Agency MBS and Australian RMBS are examples of pass-through structures.

Other ABS structures can support multiple securities, each with different

claims to the underlying cash flows. This process is known as “tranching.” By using a predefined set of rules, the aggregate cash flows from the underlying pool of assets can be redirected to various tranches to increase the safety of some securities while increasing the yield (and uncertainty of payments) of others.

Sequential tranching directs most of the principal received from the underlying loans to the most senior security in the deal. Once this bond has been retired, the next bond begins to receive principal. Most ABS deals follow this model, including auto loans, credit cards and non-Agency RMBS.

Subordination is the process of designating one tranche (or group of tranches) as senior and another tranche as junior. Similar to sequential tranching, the senior tranche receives principal first. Any credit losses realized by the pool are allocated to the junior tranche first.

Pass-through agency MBS can be further pooled into multiple tranche structures called Collateralized Mortgage Obligations (CMOs). CMO deals introduce additional redistribution mechanisms such as those based exclusively on principal payments (Principal Only, or PO), interest payments (Interest Only, or IO), expected principal payments (Planned Amortization Class or PAC) and many other variations.

Other considerations

The pool of loans or assets comprising a securitized bond deal make principal and interest payments at various times during the month. These payments are collected by the servicer on behalf of the trust, and then redistributed to bond holders on a monthly or quarterly basis. Because the return of principal is spread out over a period of time, the concept of Weighted Average Life (WAL) is used. WAL is a measure of the average time it will take to receive the expected principal payments, expressed in years. Because the timing of actual future collateral payments is unknown, WAL is an estimated — and sometimes very subjective — value. One should note that because it is an average, the last principal payment will extend beyond the WAL.

A “master trust” structure can mitigate this effect by issuing ABS with a “soft bullet” maturity where the entire principal balance is expected (but not guaranteed) to be returned to investors on a single date.

Securitized bonds are issued with a legal maturity that matches the final date of the longest asset in the pool, plus an expected workout period should this loan default on the final payment date. This accounts for the discrepancy between the WAL, which reflects the timing of expected cash flows and the longer legal maturity.

What are the risks?

The most significant risk arises from performance of the underlying collateral, in terms of both losses and prepayments. Should losses come in above expectations, senior holders could experience partial losses. Servicer performance is key during times of stress, as it impacts recovery rates. For structures relying on third-party insurers, the creditworthiness of the insurer becomes paramount.

Collateral prepayments can be volatile, leading to cash flows that are substantially different from expectations. This phenomenon is known as extension or contraction risk, and can have a significant impact on the total return of the security.

Liquidity varies greatly among collateral types. Some sectors such as Agency MBS, student loans, auto loans, credit cards and CMBS are simple or well understood by the marketplace, resulting in greater secondary liquidity. More esoteric collateral types can be substantially less liquid. Characteristics such as WAL, amount outstanding and ratings can also have a substantial effect on an individual security's liquidity profile.

The bankruptcy remote legal structure regulating securitized bonds is designed to isolate assets from creditors should the issuer default. While the “true sale”

concept has always been upheld in bankruptcy court thus far, the concept has been challenged in the past with the risk that rulings could be overturned in the future.

A potential risk exposed by the recent subprime crisis is that the collateral can be subject to adverse selection if issuers do not have financial incentive to ensure proper underwriting criteria. Fraud can

also be an issue, where actual collateral or borrower quality is misrepresented in documents.

Why invest in securitized bonds?

Mortgage- and asset-backed securities offer fixed income investors an attractive alternative to traditional corporate and government debt.

Inclusion of securitized bonds within a fixed income strategy can promote

increased portfolio diversification within the traditional mean-variance risk framework. In addition, securitized bonds typically offer superior yields relative to comparably rated securities. Finally, the diversity of collateral types, credit ratings, structures and payoff profiles makes the sector attractive to a variety of investors with very different objectives, ranging from money market mutual funds to hedge funds.

Learn More

For more information, please contact your BNY Mellon Cash Investment Services Representative, call 1-800-374-6969, or visit our website at www.bnymelloncis.com.

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