

Securitization

in Canada: *An Introdu*

Canadian financial markets may be new to the concept of turning assets such as credit card receivables, auto loans, or consumer installment loans into marketable securities, but they're catching on fast.



Securitization is the process of transforming assets into securities.

A financial institution can convert illiquid assets into capital market instruments by pooling like assets, and then repackaging the underlying cash flows to make them more attractive to investors. By creating securities, a financial institution gains access to financing sources.

Securitization is a relatively new phenomenon in Canadian financial markets. In the United States, the securitization products have developed and matured over the past 30 years or more; in Canada, the first product was introduced only in 1987. Canadian markets have been playing catch-up, and have experienced large growth rates. Over the past 5 years in particular, the Canadian product portfolio has moved beyond the initial mortgage-backed security to now encompass a variety of asset-backed securities (ABS).

What Happens in a Securitization?

The securitization process begins with a financial institution segregating, and then pooling, receivables. In the usual ABS transaction, a wide variety of asset types are eligible to be pooled, including credit card receivables, auto loans, or consumer installment loans—typically, anything other than mortgages. (Mortgages tend to be pooled and sold separately as mortgage-backed securities.) The only requirement is that each asset pool must



be homogenous with respect to credit, maturity, and interest rate risk. Size and diversity of ABS asset pools tend to minimize interest rate sensitivity.

After pooling, a financial institution sells the selected assets to a special-purpose vehicle. This special-purpose vehicle, or SPV, is responsible for both the financial re-engineering of the underlying cash flows and the sale of securities to investors. While there are various legal and accounting implications of the chosen SPV structure, the originating financial institution is generally looking for a “true sale” of the asset pool. True sale allows the financial institution to remove assets from its books, and obviates its need to hold capital against them. Making the SPV a bankruptcy-remote trust facilitates the financial institution receiving off-balance-sheet treatment. (Bankruptcy-remote means that securities sold from the trust wouldn’t be affected by the bankruptcy of the originating financial institution.)

An asset becomes securitized once it’s used as collateral for securities issued to investors—hence, the securities are said to

be “asset-backed.” The cash flows from the underlying pool of assets support the securities (usually bonds) that are sold in the marketplace. Principal and interest cash flows from the selected asset pool are passed on to the investors.

The basic cash flows involved in a securitization transaction are outlined below, with fund transfers from the financial institution to SPV to investors.

Definitions

“In mathematics you don’t understand things,” Johann von Neumann said. “You just get used to them.”

The same sentiments might apply to the technocratic language of the securitization market. The following definitions should aid familiarity and understanding.

- Asset-backed security (ABS). (See above.)
- Mortgage-backed security (MBS). Securitized interests in a pool of residential mortgages. Investors receive payments of principal and interest from the pool. Despite the fixed nature

of the underlying monthly mortgage payments, the payments made to investors can vary widely. MBS are marked by prepayment risk (mortgage holders can prepay early), and therefore are very sensitive to interest rate changes.

- *Asset-backed commercial paper (ABCP)*. Short-term money market ABS, maturity less than 1 year (usually 30-180 days).
- *Asset-backed term debt*. Longer-term ABS, maturity longer than one year.
- *Conduit*. Single-purpose trust that buys a financial institution's assets. It raises funds by issuing debt (commercial paper, long- or medium-term notes, subordinated debt).
- *Collateralized mortgage obligation (CMO)*. Type of MBS, securitized interests in a pool of mortgages. Structured in tranches (classes) of bondholders with different prepayment and maturity.
- *Commercial MBS (CMBS)*. Securitized interests in a pool of commercial mortgages (e.g., multi-family housing, hotels, office buildings).
- *Modified pass-through security*. All payments (less a servicing fee) from underlying assets passed directly to the investor, with the financial institution making up any default or deficiencies in individual payments. (The Canadian MBS product is an example.)
- *Multi-seller conduits*. Has the ability to buy assets from a wide range of companies, usually sponsored by banks or investment dealers. Segregated pools of receivables from more than one seller generally either revolve or amortize.

- *Pass-through securities*. All payments of principal and interest (less a servicing fee) from underlying assets are passed directly to investors. (The American MBS product is an example.)
- *Prepayment*. Risk of payment acceleration, particularly marked in MBS where mortgage holders have the choice to prepay. Mortgage prepayment rates move inversely with interest rate changes. Mortgage holders adversely select against the investor, who loses future interest payments on prepaid principal.
- *Single-seller conduit*. Only one seller sells financial assets to the conduit. Often sponsored by a specific manufacturing company.
- *Special-purpose vehicle (SPV)*. Financial intermediary involved in re-engineering the cash flows. Could be a trust or a corporation.
- *Trust*. A charitable trust as SPV keeps the residual funds of the transaction. Not consolidated or taxed with the financial institution. Bankruptcy-remoteness protects investors.

MBS vs. ABS

Besides MBS products securitizing residential mortgages, and ABS products securitizing just about everything else, there's another difference between the usual MBS and ABS products: Residential mortgage-backed securities have little credit risk. It's common for MBS products to involve residential mortgages that have been either insured or guaranteed by a government body. In such cases, the investor doesn't take on credit risk. Rating agency investigations are virtually obviated by any government backing of an MBS product.

In ABS transactions, however, rating agencies carefully examine credit risk, and good ratings require credit enhancements to provide a layer of protection. Credit enhancements are often based on a multiple of the selected assets' historical losses. The enhancement could take the form of a recourse provision, where the financial institution contractually agrees to cover losses up to a set amount; over-collateralization, which happens when the underlying asset value is greater than that of the security; prioritization of claims with senior-subordinated structures; or third-party guarantees, such as letters of credit or liquidity provisions.

Why Securitize?

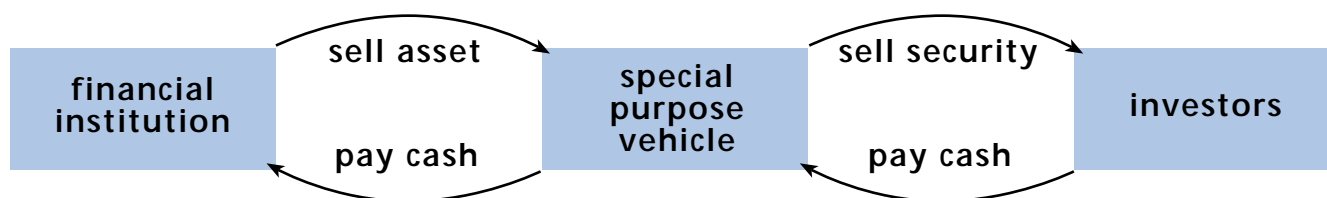
There are three basic reasons why a financial institution wants to securitize assets: asset management, funding, and regulatory performance ratios.

Asset management allows financial institutions to improve asset-liability matching. Securitizing minimizes any mismatching of cash flows, since it enables the exchange of long-term assets, such as mortgages, for cash.

Exchanging the long-term assets increases a financial institution's liquidity profile, which, in turn, gives the institution access to new, low-cost funding. Additional funding allows the financial institution to grow existing business or expand into new business areas. This additional funding is important as financial institutions continue to see declines in their traditional deposit base, and a surge in the popularity of mutual funds.

Securitization also affects performance ratios. With markets increasingly aware of declining capital ratios, financial institu-

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tions are clamoring to improve their image of strength. If a financial institution secures “true sale” accounting treatment in a securitization transaction, then securitized assets are removed from their balance sheet. Selling the assets obviates a financial institution from holding regulatory capital against them. This allows the institution to deploy that capital in other ways, and the off-balance-sheet treatment improves return-on-asset (ROA) and return-on-equity (ROE) ratios. Of course, “true sale” requires just that: All rights and interests of ownership should be transferred from the financial institution to the new owner of the asset—the investor.

The sellers also have supplementary benefits of the securitization transaction in that their clients (mortgage holders, for example) are unaware of the transaction, and original relationships are maintained. Sellers have no direct relationship with the investors.

On the other hand, there are three basic reasons why an investor wants to purchase securitized assets: asset diversification, attractive returns, and safe investments.

Asset diversification is important for investors who are seeing less volume of traditional choices with a decreased supply of government debt products. It offers additional choice, with a range of maturity and liquidity instrument profiles.

Attractive returns and predictability of cash flows have been realized with investment markets continuing disintermediation trends with a “flight to quality.” Securitization products are filling a need for secure and, in the case of ABS, rated investments. For MBS products, prepayment risk introduces variability in investor payouts, and higher yields are paid to compensate.

Securitization in Canada and the United States

The Canadian government created the Canada Mortgage and Housing Corporation (CMHC) in 1945 and gave it a mandate to ensure housing affordability and choice for Canadians. Its governing legislation is the National Housing Act (NHA), which provides for the insurance of mortgages against lender default. In 1987, amendments to the NHA allowed CMHC to introduce Canada’s first securitization product—the NHA MBS.

MBS pools are created from NHA-insured mortgages, and CMHC provides an additional timely payment guarantee on the security. The resulting product doubly protects investors against borrower default (through mortgage insurance) and financial institution default (through the timely payment guarantee).

The NHA MBS product enjoyed a monopoly in the Canadian securitization market for many years, and the product is virtually unchanged from its inception. There have been some efforts to revitalize the product lately, given the potential market size. In Canada, only about 4 percent of residential mortgages are securitized, compared with about 47 percent in the United States.

In the United States, government organizations play a large role in either insuring the underlying mortgages or guaranteeing the MBS payments. Mortgage insurance is often provided by the Department of Veterans Affairs (VA) or the Federal Housing Administration (FHA). Private companies also provide mortgage insurance.

Three U.S. bodies are then involved in guaranteeing mortgage-backed securities. The Government National Mortgage Association (GNMA, commonly called Ginnie Mae) is a U.S. government corporation, and its MBS product provides a guarantee involving FHA and VA loans. Ginnie Mae’s guarantee is backed by the full faith and credit of the U.S. government.

The Federal National Mortgage Association (FNMA, or Fannie Mae), and the Federal Home Loan Mortgage Corporation (FHLMC, or Freddie Mac) are government-sponsored entities that carry the implicit backing of the government—meaning they would likely not be allowed to fail. Fannie Mae and Freddie Mac MBS programs involve conventional mortgages, along with some FHA and VA loans. While non-agency MBSs are common (especially for jumbo loans, or mortgages that otherwise

don't meet the corporations' criteria), the three government organizations dominate the mortgage-backed-securities market.

In Canada, CMHC or *Cannie Mae*, a Crown corporation of the Canadian government, is the only government organization involved in both insuring mortgages and providing a guarantee on the MBS payments. The CMHC MBS product is virtually the only MBS product in the Canadian market.

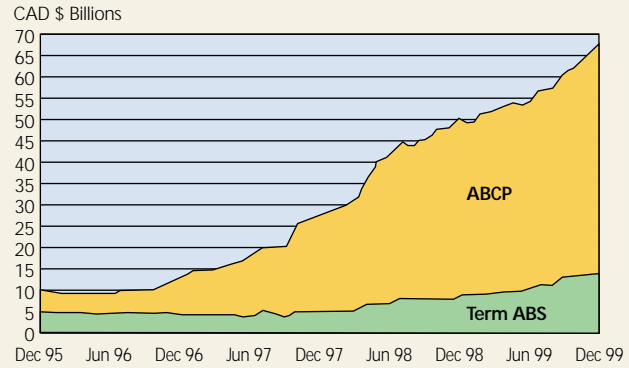
Market Developments

The NHA MBS product was introduced in 1987, with financial institutions securitizing residential mortgages. Growth in NHA MBS issue levels has taken off in recent years, with the original \$456 million in issues in 1987 rising to \$6.9 billion in 1997, \$9.1 billion in 1998, and \$12.9 billion in 1999. Taken by itself, the NHA MBS product has been experiencing phenomenal growth. During its first years, the product was largely dominated by Canadian trust company issues. In recent years, the larger Canadian banks have started to issue NHA MBS products, which, in part, led to the large growth in new issue levels.

While NHA MBS volumes have been increasing significantly, that growth seems less remarkable when compared with the growth experienced in ABS markets in Canada over the same time period.

Around 1990, the first Canadian conduits experimented with the issuance of asset-backed commercial paper (ABCP). This development involved single sellers with small portfolios, us-

Total ABS Market Growth of Securitization



ing short-term trade receivables. A recession a year later, along with a decline in credit quality, led institutions to consider other sources of funding. The first ABS term product was introduced with the underlying asset being consumer receivables. In 1993, the first private-label securitizations were done using equipment loan leases and receivables.

Canada's ABS securitizations grew from those first structures. Outstanding issuances of multiseller ABCP grew from about \$2.5 billion in 1992 to \$34 billion in 1998 (or \$40 billion, including single-seller figures). ABS term annual issuance tripled from less than \$1 million in 1991 to about \$3 million in 1998. In addition, the asset class changed from retail auto to credit cards. Volumes of ABS outstanding increased 183 percent in two years, and the growth is continuing. As the larger banks and other financial institutions enter both the NHA MBS and other securitization markets, securitized assets are likely to increase.

The growth in Canadian securitization products is expected to continue for the near future. For the institutions—the seller side—the report of the MacKay Task Force on the Future of Financial Services in Canada, released in September 1998, noted that: Securitization is a far-reaching innovation for two reasons. It allows institutions to use their capital more efficiently by transferring the loans from their own balance sheet, usually retaining a management fee for administering the loan. Spread income becomes converted to fee income, and capital is conserved. Second, securitization permits separate financial institutions to originate, fund, service, and assume risk related to a portfolio of loans or other assets.

MacKay noted that the development of specialized expertise will assist competition, and essentially competition will drive the future of financial services in Canada. Securitization will be key to financial institutions' positioning.

For the investor—the buyer side—disintermediation trends continue to move with a "flight to quality." Government budget-balancing initiatives have dried up government debt issuances, without an accompanying surge in corporate issuances. Investors are looking for secure products with good returns. Securitized assets will provide an option and will no doubt continue to thrive.

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