TRIPLE-A RATED SECURITISATION

ATTRACTIVE RISK/RETURN RATIOS TO MANAGE EXCESS CASH

Alain Richier outlines the benefits of using triple-A rated floating rate tranches of securitisation over the money market index

At a time when classical short-term Ucits funds enjoy large inflows, the issue facing asset managers is to create value, especially as the short-term yield curve is almost flat and credit spreads are being squeezed. In this context, investing in triple-A rated floating rate tranches of securitisation is an innovative opportunity to achieve yield enhancement compared to a money market index while maintaining very low risk.

SECURITISATION

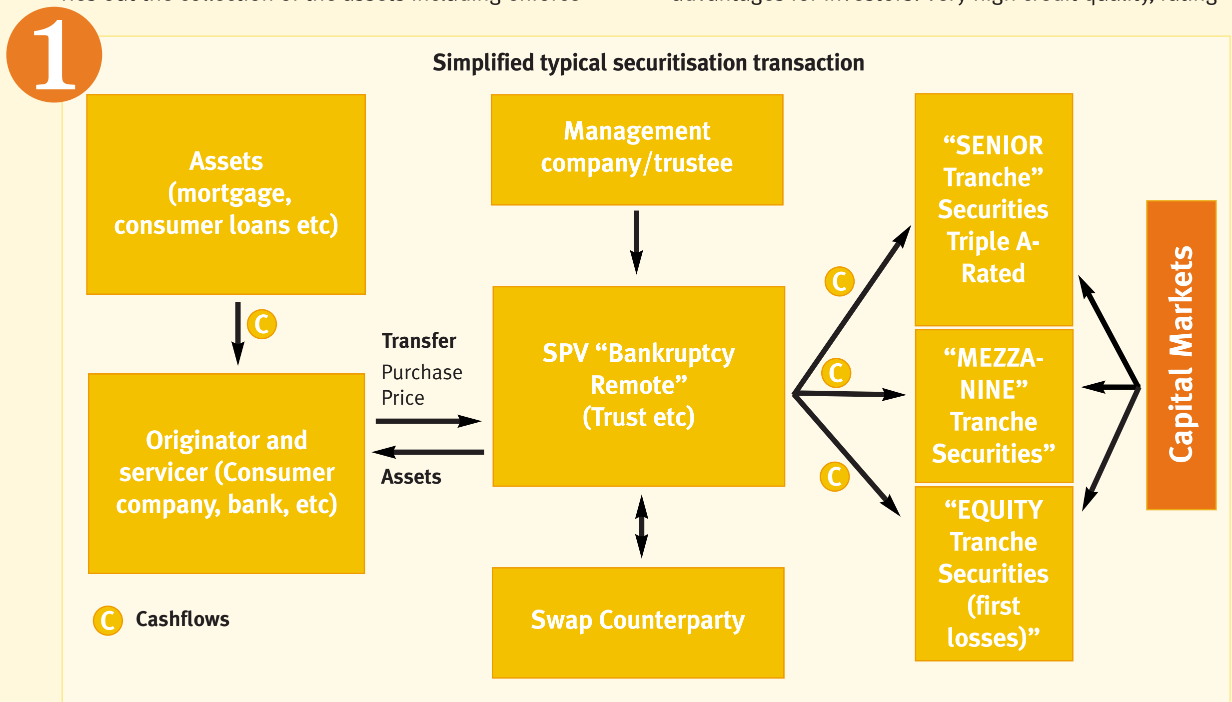
Securitisation is based on the transfer of a pool of assets (mortgage loans, consumer loans, car leasing, SME loans, etc) owned by an 'originator' (a bank, a consumer credit company, etc.) into a bankruptcy remote special purpose vehicle (SPV) to segregate them. Finance will then be raised against the future cash flows from, and security of, this pool of assets. Thus, securitisation – or asset-backed finance – converts illiquid financial assets into liquid financial assets.

The 'arranger' (often a bank) sets up the securitisation deal and manages the sale of the asset-backed securities to investors. The servicer, who is often the originator, carries out the collection of the assets including enforcement proceedings. A trustee administers the securitisation transaction, manages the inflow and outflow of money and represents the interests of asset-backed securities holders. Should the type of interest earned by the assets or the currency be different to that of the securities, the SPV would most likely enter into a swap contract with a bank counterparty to neutralise these risks. A simplified securitisation structure is shown in chart 1.

There are generally several classes of asset-backed securities within each transaction, and each class is called a 'tranche'. Each such tranche has its own risk characteristics. In a typical European securitisation transaction, the tranching is done by credit risk and/or maturity as illustrated in chart 2.

The holders of the 'equity' tranche would bear the first credit losses (after excess spread and reserve fund which are generally included in most transactions), if any. Holders of the 'mezzanine' tranche would then start absorbing losses should the 'equity' tranche prove insufficient. The 'senior' tranche therefore benefits from the subordination of the equity and mezzanine tranches. The senior tranche is generally rated triple-A. The level of subordination is calculated by rating agencies based on stress test statistics to achieve this triple-A rating. Other types of credit risk protections generally also exist in the transaction.

Triple A-rated asset-backed bonds offer numerous advantages for investors: very high credit quality, rating



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Typical tranching

SPV Balance

Assets | Liabilities

Assets (mortgage, consumer loans etc)

"SENIOR Tranche trile-A rated" securities

"MEZZANINE Tranche" securities

"EQUITY tranche" securities

First layers of protection {
Reserve (cash)
Surplus Margin

stability, and therefore price stability. Still, remuneration remains attractive compared to other AAA-rated securities like government bonds or even lower-rated bank or corporate bonds. However, each transaction is idiosyncratic and financial complexity must be dealt with.

EUROPEAN MARKET

The European securitisation market is enjoying steady growth with over €250bn euros of issuance expected in 2005 according to European Securitisation Forum. This is still modest by US standards so more growth potential exists. The main asset classes are the following:

- **RMBS (Residential Mortgage Backed Securities):** Securities backed by residential mortgage loans to private individuals. Such bonds are backed by thousands or tens of thousands of loans, thus offering strong credit diversification, often called 'granularity'. In 2004, issuance accounted for €137bn in Europe, of which the UK accounted for 51 per cent, the Netherlands 13 per cent, Spain 12 per cent, France 10 per cent, and Germany and Italy only 5 per cent.
- **CMBS (Commercial Mortgage Backed Securities):** Securities are backed by mortgage loans financing commercial or company property (offices, warehouses, specialised premises, shopping centres, etc.). This securitisation class generally covers just a few or several large-scale loans, financing only a few hundred properties at most. In some cases, the asset backing the bonds may be only one single 'trophy' property. In 2004, issuance accounted for €17bn in Europe, of which 58 per cent is in the British market.
- **Consumer ABS (Asset Backed Securities):** Securities are backed by loans such as credit card receivables, personal consumer loans or auto loans. In 2004, issuance accounted for approximately €1bn in Europe, of which 40 per cent was on car ABS (half originating in Germany) and 33% on credit card ABS (the British market only).
- **Trade Receivables:** Securities are backed by various receivable bills (commercial or leasing debts). In 2004, issuance accounted for approximately €10bn in Europe, 90 per cent originating in Italy.
- **CDO, CLO, CBO:** CDO (Collateralized Debt Obligation) is a generic term originally describing a securitisation where the debts were initiated by the assets (bonds or loans generally granted to companies), but which today encompasses other classes of financial assets. To date, CDOs include: loans to companies (CLO: Collateralized Loan Obligation), with CLOs categorised by loan type, such as the SME (Small and Medium Enterprises) CLO, or the Leveraged Loan CLO for financing LBO operations; bonds (CBO: Collateralized Bond Obligation), primarily for companies, but also occasionally for emerging countries; CDS (Credit Default Swap), instruments allowing for credit risks to be transferred into synthetic securitisations; ABS (Asset Backed Securities), generally containing individual debts (credit card debts, car or consumer loans), in these cases, one generally refers to ABS CDO. In 2004, public issuance accounted for €47bn in Europe of which 60 per cent was in classic securitisation and 40 per cent in synthetic.

Within these classes, why opt for AAA-rated tranches? First and foremost, AAA-rated tranches offer the most security. Triple A-rated tranches also account for over 80 per cent of issuance over the last four years. (Source: Lehman Brothers).

TRIPLE-A BENEFITS

Investing in AAA-rated asset-backed tranches offer investors two main benefits.

Firstly, as asset-backed bonds, they offer high diversification. Indeed underlying assets may be very large, representing up to several million individual borrowers in the case of credit card master trusts. This produces a very interesting 'granularity' effect, not least because individuals may work in all the sectors of the economy. At the portfolio level, even higher diversification can be achieved by investing in all asset-classes (RMBS, CMBS, ABS, etc.).

Secondly, AAA-rated asset-backed bonds offer a high level of intrinsic security because of the following characteristics:

- **The strong alleviation of event risk:** the assets are sheltered in an SPV, with no M&A, or LBO unlike corporate bonds;

- **The existence of triggers:** if the performance of the underlying assets drops below a certain level, the senior tranche would become the priority receiver of cash flows;
- **The rating:** it is more based on a statistical approach rather than a qualitative one. Indeed, for the past 20 years, AAA-rated securitisation has been a most stable asset class with 99 per cent year-on-year rating stability against only 92 per cent for AAA-rated corporate bonds, according to Moody's (1983-2004 survey).

Triple-A rated asset-backed bonds offer low risk combined with a sufficiently attractive return to allow the creation of 'excess return' against a money market index as shown in the graph below. In actual fact, these bonds currently yield an average of around more than 10 basis points over Libor with an average three to four years maturity (see chart three).

However, each transaction must be carefully screened and selecting the best of them remains a specialist role. Analysing SPVs requires a real know-how in complex financial arrangements. Natexis Asset Management has been an experienced investor in the securitisation market for more than 10 years.

Its newly created fund, Natexis Money + AAA aims at offering investors a convenient way to enjoy the benefits of the AAA-rated asset-backed bonds. The fund is benchmarked to the Eonia (European Overnight Index Average) and as such has zero duration. Yield enhancement above the benchmark is to be obtained by exposure to AAA-rated asset backed bonds.

Natexis Money + AAA has already recorded over €500m net sales in less than six months since its inception.

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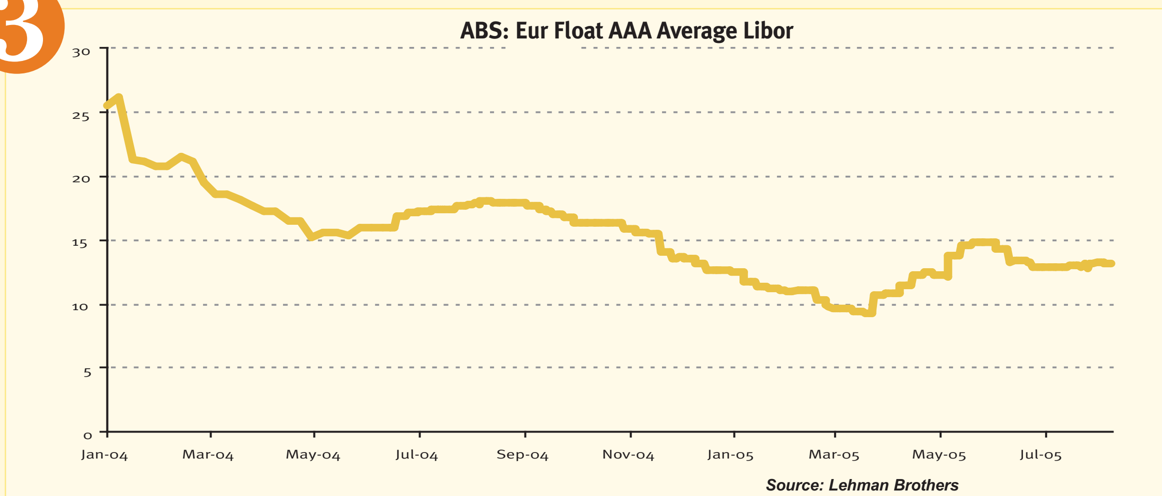
Alain Richier, head of money market division, Natexis Asset Management



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CORPORATE STATEMENT

Natexis Asset Management is the asset management subsidiary of the Banque Populaire Group. Managing assets worth €91bn, Natexis Asset Management is a leading player in the French market. It ranks fourth in terms of global market share, and leads the market in salary savings accounts. Natexis Asset Management serves the interests of its individual and corporate customers by offering a comprehensive series of funds, covering a wide range of markets, risk/return ratios and investment areas.