MBS, ABS, SPV, CDS, ARM, BBB+: Understanding the Alphabet Soup of Securitization

Mark Fagan
Tamar Frankel

October 2008
Causes of the Financial Crisis

Deregulation
Securitization
Housing Bubble
Subprime Loans
Greed
Home Ownership Policies
Predatory Lending
Derivatives
Cheap Money
Conspiration Mania
Rating Agency Failure
Presentation Objectives… 

- Explain the basics of securitization.
- Provide perspective on the role of securitization in the financial crisis.
- Discuss the role of securitization in solving the crisis.
Securitization Defined

Intermediation to create tradable securities from the cash flow of pools of non-liquid assets

- Frankel and Fagan
Making The Definition Transparent

Intermediation to create tradable securities from the cash flow of pools of non-liquid assets

Borrowers  Intermediaries  Lenders

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Making The Definition Transparent

Intermediation to create tradable securities from the cash flow of pools of non-liquid assets

First Bank of Newton

30 Year Mortgage
Mark Fagan
$300,000
7% fixed interest
Making The Definition Transparent

Intermediation to create tradable securities from the cash flow of pools of non-liquid assets

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Cash Flow
2009   $13,930
2010   $13,930
2011   $13,930
2012   $13,930
2013   $13,930
2014   $13,930
...
Intermediation to create tradable securities from the cash flow of pools of non-liquid assets
Making The Definition Transparent

Intermediation to create tradable securities from the cash flow of pools of non-liquid assets

Tradable: Standard form + Similar terms

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<th>Symbol</th>
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<th>Last Trade</th>
<th>Date/Time</th>
<th>Volume</th>
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The Rationale for Securitization

1. Increases capital availability

Sources of Capital

- Private Equity
- Bank Deposits
- Sovereign Wealth Funds

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1. Increases capital availability

**First Newton SPV**

*Mortgage-Backed Securities*

6%

*Passthrough*

8 Year Average Life

**First Bank of Newton**

*30 Year Mortgage*

Mark Fagan

$300,000

7% fixed interest
The Rationale for Securitization

2. Lowers the cost of capital

Comparison of Funding Cost of Sperry Leases

Value of Securitization

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The Rationale for Securitization

3. Isolates risk

MFTF Partners

- Full Occupancy
  - 10 Year Lease

- On Spec
  - Las Vegas
  - 2007
4. Creates a broad array of attractive investment options

The Rationale for Securitization

Return

AAA

AA

A

BBB+

BBB

Risk

Source: troweprice.com/common/gcDefaultWide

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The Basic Process

Borrower → Lender/Originator → SPV → Investor

Assets

Cash

Cash Repayment
Process Facilitators

- Appraiser
- Lender/originator
- SPV
- Investor
- Servicer
- Rating Agency
- Securities Brokers

Borrower
“Manufacturing” Securities

Step 1: Pool Assets

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2008
“Manufacturing” Securities

Step 2: Enhance Credit

• Guarantees: Buying insurance
• Retain Principal: Hold initial principal repayment in the SVP as a cushion
• Over-collateralize: Issue less securities than the underlying value of the assets
“Manufacturing” Securities

Step 3: Divide into Tranches (aka slicing)
“Manufacturing” Securities

Step 4: Obtain Ratings

Ratings are: “forward-looking opinions that speak to the relative probability that principal and interest will be repaid in a timely manner”

Ratings are NOT: “recommendations to purchase…do not comment on the suitability of an investment…”
“Manufacturing” Securities

Step 4: Sell the Securities

Investment Banks:
Bear Stearns, Wachovia, Merrill Lynch
Citigroup, Deutsche Bank

“Securitizes”:
Fannie, Freddie, Ginnie

Broker Dealers
“Re-Manufacturing” Securities

Re-pool Tranches

First Newton MBS

First Newton MBS Junior B
"Re-Manufacturing" Securities

Create silk purse from a sows ear!
The Primary Product Offering

MBS – Mortgage-Backed Securities

Cumulative Amount of Ginnie Mae MBS

Source: Ginnie Mae 2007 Annual Report

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Another Key Product Offering

ABS – Asset-Backed Securities

ABS Auto Issuance

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Source: Asset Backed Securities Bhattacharya and Fabozzi
More Products

• Credit card debt
• Student loans
• Hospital accounts receivables
• Legal awards
• Lottery winnings
Accompanying Market in Risk

CDS – Credit Default Swaps

**Derivative**: A security whose value depends on the value of other underlying financial instruments.

**A contract**

**CDS**: “Insurance” against an outcome.
Accompanying Market in Risk

CDS – Credit Default Swaps

A Common Credit Default Swap Transaction

- **Protection Seller**: Does not usually own underlying credit asset, Selling Credit Protection, Long Credit Exposure.
- **Protection Buyer**: Tends to own underlying credit asset, Purchasing Credit Protection, Short Credit Exposure.

Accompanying Market in Risk

CDS – Credit Default Swaps

Securitization – Law and Regulation

- **Borrower**
  - **Contract**

- **Appraiser**
  - **Common Law & Legislation**

- **Lender/Originator**
  - **Banks: Banking Laws**
  - **Mortgage Bankers – Unregulated**
  - **Mortgage Brokers – Unregulated**
  - **Derivatives Market Unregulated**

- **Servicer**
  - **Trust Indenture Act 1939**
  - **Banking Law**

- **SPV**
  - **True Sale Bankruptcy**
  - **Tax 1940 Act**

- **Investor**
  - **Property**

- **Rating Agency**
  - **Monopoly Advisors Act 1940**

- **Securities Brokers**
  - **Securities Acts**
  - **Self-enforcement**

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The Case Against Securitization

1. Created several Moral Hazards
   • Lenders/Originators
   • Appraisers/raters
   • Investors
2. Increased the distance between borrowers and lenders
3. Encouraged predatory lending
4. Introduced complex products capable of misuse/abuse
5. Required “off-balance sheet” transactions
Securitization and the Financial Crisis

The Defense

1. Enabled millions of families to become responsible homeowners over 3 decades; enabled corporations to finance their businesses at a lower cost of capital
2. A broad array of risk-return products brought new capital into the housing and asset markets
3. The process is sound; individual participants violated their trust (The Arsenic Defense)
Securitization and Solutions

- Disclosure is NOT the solution!
  - Complex
  - Networking and following the crowd
- Investigate and enforce existing law
- Restore Trust
  - Fiduciary responsibilities of intermediaries
  - Rating agencies – rate OR consult
  - Apologies and compensation give-backs
  - Regulate mortgage brokers and bankers
  - Bring derivatives under the tent
Conclusion

• Securitization is a valuable tool

• Don’t throw out the baby and bathwater: Change the water

Water can sustain you and KILL you!

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