Asset Securitization Perspectives

Part I of “Until I’m Done”

On August 25th, CU Revest submitted a comment letter to the NCUA related to its proposed rule on asset securitization. The rule, as it read for comment, was reasonably vague in scope and essentially said, “The NCUA has never allowed or disallowed securitization, but we think we ought to allow it, so here are the rules under which we will do so”. Clearly, I’m paraphrasing. The rule, however, did not purport to be a strict dictation to CUs about what would be an acceptable securitization and, as such, did not provide many specific details. Not to ruin the punch-line, but I think that securitization is an excellent tool for credit unions, but I have to admit, I’m a little biased. In a series of articles, I’m going to be discussing securitization in general and some aspects of it that I think are pertinent to credit unions in a little more detail and at times in way more detail. In some aspects these articles will be broad and even colloquial while in others they will be very specific—my hope is that each is allocated appropriately.

In this first article, I am going to discuss securitization in general including what it is and scratch the surface on the legal structure and the participants in the process.

First, a little about me. My introduction to securitization came in 2000 when I was fortunate to join Dain Rauscher (now RBC Capital Markets) as a junior investment banker in the taxable fixed income group in Dallas. At the time, the group was small and focused nearly exclusively on asset securitization. I spent three years there until I and the majority of the group left to join Harris Nesbitt (now BMO Capital Markets) in their U.S. Securitization Group where I stayed until 2006. Both practices focused on middle market issuers with a specialization in first time issuers. As most credit unions that would contemplate securitization fit both categories, I regard this coincidence as a stroke of good fortune. In the simplest terms, the word securitization broadly defines a process whereby a holder of loans can convert those loans to a series of bonds. I’m going to admit that the preceding sentence is a simplification that may offend those with delicate sensibilities. In fact, those “loans” could be leases, credit card receivables, accounts receivable—the list goes on and on, and those “bonds” could actually be bonds, or notes, or certificates, or something else. Yes, I’m going to generalize because otherwise every sentence would be as convoluted as that one.

At its core, the purpose of securitization is to allow owners of loans (issuers) to structure a secured borrowing in such a way that the bondholder/investor, who is ultimately the lender, is exposed to the minimum amount of credit risk. This minimized credit risk equates to lower risk premiums which equates to lower interest rates for the borrower. The best example of this is companies that don’t even have corporate credit ratings issuing bonds that are rated AAA/Aaa by Moody’s and S&P. Those bonds pay interest at a rate that is much less than what the company would have to pay if it borrowed on a direct corporate basis. I offer this as a tangible example and will discuss bond ratings, their methodology, and when they are and are not necessary in a later article.

"Credit enhancement" is the general term referring the methods by which the bonds are made less risky than lending to the issuer directly and even less risky that being secured by the loan collateral only. Credit enhancement to the loan collateral takes many forms which will be discussed later, but for the time being, I'm going to focus on the legal structure that protects the investor from the credit rating (or, more accurately, lack thereof) of the issuer. That legal structure is the formation of a special purpose entity.

In this paragraph, some of my generalities start catching up with me. I have been referring to the credit union that holds the loans as the issuer. This is not technically correct. The credit union that owns the loans is more accurately referred to as the seller. The CU is the seller because it sells the loans to the issuer…let me expound. In order to securitize assets, the credit union will form a bankruptcy remote special purpose entity (SPE). This entity will do two things and two things only. It will issue bonds (thus this SPE is technically the issuer) and it will own loans. It will have no employees, it will have no other assets, it will have no other liabilities. The purpose of this is to ensure that the SPE's sole liability is the bonds. The SPE is bankruptcy remote so that if the credit union gets into financial trouble, it cannot consolidate the SPE into its bankruptcy. (I realize that this is not the course of a troubled credit union, but the underlying legal structure serves the same purpose—isolate the SPE from any issues that would have arisen from a direct loan to the seller.) This bankruptcy remoteness can be achieved through a few different means and become very technical legally. It is also often the case that two new entities are formed, a depositor and an issuer, in what is called a two-step transfer. The important take-away is that the assets become property of an SPE, that SPE is separate from the original owner of the assets, that SPE issues securities, and the proceeds of those securities flow to the original owner of the loans who sells those loans to the SPE. This process is the best way to understand the otherwise counterintuitive naming conventions. The original owner actually sells the loans, the SPE actually issues the securities in order to buy the loans, and the investors purchase the bonds secured by the loans.

Couldn't be simpler, right? Well, don't be disappointed, it's not that simple. There are servicing agreements, residual interests, structural credit enhancement, back-up servicers, clean-up calls, tranching, triggers…you get the idea. But those are topics for another day.

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Jason Micheletto serves as Executive Vice President of CU Revest as well as Servatus, and has 15 years' experience in the capital markets, including structured finance, asset-backed securities, and lending. He also serves as President of DPM, the consumer finance company affiliate which originates refinance loans to eligible members to aid in their recovery. He began his corporate finance career at RBC Dain Rauscher as an analyst and subsequently served as Vice President at BMO Capital Markets and PBL Capital. While Mr. Micheletto has worked with several different asset classes, he has specialized in distressed, non-performing, and re-performing debt. Since joining Servatus in 2009, he has focused on cash flow modeling and projections, portfolio analysis and pricing, and oversees the trading desk related to portfolio resale activities.