International developments in securitisation

By Patrice Jordan

THIS paper is concerned with developments in securitisation, focusing on the capital markets where rated mortgage-backed issues either exist already or have the potential to develop in the future. It starts by defining what is meant by securitisation, and then examines the reasons why securitisation may be attractive to both originators and investors. It then discusses the developments Standard & Poor's has seen so far — in the UK, Canada, Australia and New Zealand — and concludes by describing what might develop in other countries in the future.

TO some extent the word securitisation, and the process it implies, has come to mean whatever the user of the word chooses it to mean. Keeping that in mind, my own definition is that securitisation is a subsector of the much broader subject of disintermediation — where borrowers bypass financial institutions, and find funding directly with the end-investor.

Securitisation is the process by which existing assets are used as collateral with which to raise funds in the capital markets. These assets can range from consumer receivables such as credit cards and automobile loans, to trade receivables such as leases and accounts receivable, to residential and commercial mortgage loans.

The developments I will be discussing will be those in securitisation of residential mortgages in countries in which Standard & Poor's has already been, or may in the future, be involved.

This last statement requires me to draw a distinction between mortgage-backed bonds and rated mortgage-backed bonds. There have been markets for mortgage-backed bonds in continental Europe — notably Germany, Scandinavia and Italy — for many years. These have functioned well, and to date Standard & Poor's has rated only a few of these issuers' obligations, notably those of Frankfurter Hypothekenbanken and Rabo Hypotheebanken. Our credit ratings tend to be useful to issuers who want to tap investor markets outside their home country, or who want to develop a new type of security previously unseen in their market, or who live in a ratings-sensitive market, such as the US.

So, while the concept of securitisation is not new, the subject has been given new life for a variety of reasons. From the origination side, there are three main factors which have driven the development of the mortgage-backed securities markets in the five countries Standard & Poor's has rated issues — the US, the UK, Canada, Australia and New Zealand. These factors are asset/liability matching, capital requirements and funding costs.

It is necessary to keep in mind, however, that not all these factors have been present in each country, and even where all factors do exist their relative importance varies from country to country.

Asset/liability mismatch, together with regional supply and demand, is widely regarded as the driving force for mortgage-backed bonds in the US. Lending fixed, long-term money funded by floating, short-term money rarely succeeds over the long term. This is why the German financial institutions have traditionally raised long-term bonds to fund their long-term mortgage assets.

However, in the UK, Australia and New Zealand, rates are flexible and can be moved to keep a steady margin over funding costs. Moreover, until quite recently, depositors' funds were remarkably stable. In Canada, while rates are fixed for a term, that term is limited to one, three or five years, thereby minimising the maturity risk and the interest rate risk. So asset/liability mismatch is not always a key reason for the development of these securities.

Capital requirements and overall profitability which encourage banks to shed assets while maintaining the related fee income seem like they would encourage all financial institutions to pursue this route. However, in the UK, Australia and New Zealand, building societies largely fall within their regulatory guidelines already, and banks, while curious, have not been the driving force in securitisation of mortgage assets.

Funding costs have been important considerations in both the US and UK, though for rather different reasons. In the US, wholesale funds became cheaper than retail funds for a time after deposit rate deregulation. In the UK, the major users of securitisation to date have been financial institutions without deposit bases, so they must use the whole-

12 ⟶

← 11
sale markets for funding. This need resulted in the creation and subsequent rapid growth of the UK mortgage-backed bond market in the past few years.

In Australia, New Zealand and Canada, the major mortgage lenders have so far been able to rely on sufficient relatively cheap retail deposits for funding their mortgage books, and to the extent securitisation has occurred, diversification of funding sources, rather than costs, have been more of a reason.

Another factor, government support, does not fall into the category of originator demand, but has been important in the US, Canada and Australia. Fannie Mae, Ginnie Mae and Freddie Mac have been instrumental in facilitating the US mortgage-backed bond market. In Australia, two state sponsored entities — the First Australian Mortgage Acceptance Corporation, or FANMAC, and the National Mortgage Market Corporation, or NMMC — have established several mortgage-backed programmes in New South Wales and Victoria, respectively. And in Canada, the Canada Mortgage and Housing Corporation, CMHC, has been a primary player in the Canadian domestic mortgage-backed bond market.

From the investor side, there are several factors, both positive and negative, which have affected demand for mortgage-backed securities. High yields, together with high credit quality, have been positive factors driving investor demand, while the uncertain actual maturity of the security, due to uncertain timing of mortgage prepayments, has been a negative factor. Market liquidity is usually a negative until the market has proven itself over time.

One final factor — the search for tradeable assets — is what I would call banker-generated demand. Trading mortgage-backed securities has been very lucrative in the US, and, therefore, there is a strong incentive to replicate such a profitable business elsewhere. This has been particularly prevalent in the UK, with Salomon Brothers establishing one of the first specialised mortgage lenders — The Mortgage Corporation, or TMC. I would expect this practice to continue.

I would now like to discuss briefly the developments seen so far in the UK, Australia, New Zealand and Canada.

The first UK mortgage-backed public rated issue was completed in March 1987. Since then there have been approximately 45 additional public issues, as well as a number of private transactions. The issues have been almost exclusively floating rate note issues with bullet maturities of approximately 25 years. This structure fits well with the UK mortgage product which is variable rate, interest only, usually with 20- to 30-year maturities. The expected average lives of the issues have been five to seven years, although there have been some recent issues structured with multiple tranches where the first and second tranches at least are expected to have much shorter average lives. And some issues have allowed mortgage substitutions funded by prepayments to help delay principal prepayments.

The spreads over three month Libor have ranged from a high 37.5 basis points to a recent low of 18 basic points. As you would expect, the spreads have narrowed as the market has matured. A recent departure from the 25-year floating rate note structure was a five-year fixed rate issue which included both a swap contract and a put agreement. In addition, last year two commercial paper programmes were issued in an attempt to access the US commercial paper markets. Variations on the standard endowment life policy-linked mortgage product, such as a number of low start schemes, have been introduced to issues over the past year. I anticipate that experimentation and innovation will continue on both the asset and funding sides.

In Australia, the securitisation of mortgages primarily has involved non-standard rather than standard residential mortgage products. Mortgage types that have been securitised include those for multifamily residential investment properties, low start owner-occupied residential homes, and small commercial properties, as well as some standard residential mortgage products.

Conventional owner-occupied residential mortgages have not been the predominant type included in securitised pools primarily because the major lenders — the four trading banks and the state banks — have been funded adequately through retail deposits. In addition, the short-term, fixed rate nature of the Australian securities market does not fit well with the long-term, variable rate standard mortgage product. The state government assisted mortgage agencies mentioned earlier — FANMAC and NMMC — have issues backed by low start mortgages geared to help low and middle income first-time home buyers — with liquidity and credit support provided by the respective state governments. Also, NMMC has established two commercial paper programmes used to fund a variety of mortgage types.

Several private entities have issues with three- to five-year maturities and these have been collateralised by mortgages with fixed rates and matching maturities. I expect, over time, that a number of the second tier mortgage lenders, such as the building societies, will enter the securitised market. And to the extent securitisation is an economically viable source of funding diversification, some of the major banks as well.

In New Zealand, securitisation seems to be gettting started. In March 1989, the United Building Society launched a mortgage-backed issue, GMBS International No 1. It is a US dollar three-year fixed rate issue backed by variable rate long-term residential mortgages, insured by Financial Security Assurance and issued in the euromarkets. Whether or not securitisation is necessary in New Zealand remains to be seen, but the issue has been, at the very least, a successful experiment.

In Canada, a domestic market for mortgage-backed issues exists due to government support from the Canada Mortgage and Housing Corporation, a federal Crown corporation. Mortgages insured under the National Housing Act are used as collateral for these issues, nicknamed "Cannie Maes". Principal on the mortgages is guaranteed by CHMC which also issues a timely payment guarantee for the mortgaged-backed securities. Cannie Maes were first issued in January 1987. GMC Investors Corporation has issued mortgage-backed securities since 1985.

Canadian residential mortgages are typically written for one, three or five years. During the term, interest rates are fixed, and monthly payments of interest and principal follow an amortisation schedule of up to 30 years. At the end of the term, the originator usually renews the mortgage at a newly fixed interest rate. Alternatively, the originator may require repayment of the outstanding principal balance. Mortgage prepayments may be permitted at any time during the term.

Two Canadian dollar euro issues by Royal Trustco Mortgage Finance, issued in the past year, demonstrate how the mortgage-backed securities structure can be adjusted to best fit the asset terms. Both issues are fixed rate, with five-year maturities. Mortgages in the underlying pools are fixed rate, with five-year maturities. Any mortgage prepayments are reinvested by the issuer with scheduled maturity.

That concludes my discussion on developments in international mortgage-backed securitisation to date. I would now like to discuss several potential future developments.

First, on a general level, any country has the potential to develop a mortgage-backed securities market. Whether there is sufficient market interest, incentive, or a large enough volume of securities to make the effort worthwhile, is the starting point for consideration of the advantages of this market. Let us take the examples of France and Japan. To begin with, both markets have sufficient volumes of mortgages outstanding to make securitisation viable.

In France, the factors I discussed earlier, including government support, are clearly encouraging the development of such a market. In February of last year a new law was passed designed to enable a wide variety of issues to be securitised, as well as to broaden the investments available to participants in France's domestic capital markets.

Further regulations elaborating on the basic law have since been issued. The vehicle used to create these securities is a variation on the OPCVM, the current funds concept in France. The new funds — Fonds Communs de Creances — or FCC — are intended to hold assets, and issue the collateralised securities.

It appears that significant demand exists among originators for these instruments because they assist in asset and liability management, and decrease the need for capital for loan originators. Even if only one-third of new originations of mortgage loans were securitised, the annual issue level would be approximately FF70 billion, or $12 billion.

However, current competition for consumer mortgage business has resulted in rates which make it difficult to offer any significant spread on mortgaged-backed securities relative to other high quality debt instruments. This is particularly true for current originations; more seasoned loans on lenders' balance sheets offer somewhat greater potential for attractive rate differentials.

However, their scale could cause asset and liability management problems if they are already match funded.

Japanese investors are already keen buyers of international asset-backed securities. Japanese financial institutions, on the other hand, are currently limited to fairly restrictive provisions regarding the use of domestic Japanese assets to create asset-backed instruments in their home markets.

As in other countries, the implementation of the BIS capital adequacy guidelines and the rapid integration of international developments into domestic financial markets have caused both financial institutions and regulators to begin to look at these instruments.

In the future, a number of other countries may develop securitisation markets, either in their home markets or abroad. The real impetus to securitisation is to be able to equilibrate mortgage supply and demand wherever they may be. This means selling UK mortgage securities to Japanese investors, and US securities to European investors. This is how securitisation is most likely to have real value for originators and homeowners in reducing the cost of mortgage money, and real value for investors if they can earn more outside their home markets than they can within it — for the equivalent risk.

I encourage everyone to think in terms of his own home markets. Consider the availability of sufficient residential mortgage finance looking forward, the applicability of the investor and originator demand factors, and the degree of any government support, to arrive at your own conclusions as to where mortgage-backed securities may emerge next. ■

PATRICE JORDAN is vice-president, Standard & Poor's Corporation, New York. This paper was given to the International Union Congress in September 1989.