Development of a Liquid Secondary Market for Securitized Assets in New Countries

by Robert Sheehy

Securitization is becoming established as a new financial technique in a growing number of countries. An important step in ensuring that securitized products pass beyond novelty status is to develop such products as desirable investments for institutional investors. In fact, development of a liquid securitization market for securitized assets is not possible without the participation of the institutional investor community.

Such investors are the only ones who can provide the necessary funds required for such investments. They are also best able to dedicate the time necessary to understand the risks and profits involved. In those European countries where a securitization market has already begun to emerge, the development of a hard core of institutional investors has always been a crucial step in establishing securitization as an important financial product.

ADVANTAGES FOR THE INVESTOR

Securitization transactions will be of interest for institutional investors only if the following three conditions are met:

Robert Sheehy is Senior Managing Director, Bear, Stearns International Limited, London, United Kingdom.

1. Attractive yield
2. High rating
3. Good liquidity

The arranger/structurer of the transaction can insure that the first two conditions are met by structuring the bonds with a Aaa rating and by fixing their yield at a higher level compared with similar corporate paper with the same rating.

By contrast, the liquidity of securitized products is not easily created or guaranteed, particularly in new markets where few transactions have been realized, and existing market volume is therefore low or nonexistent. The liquidity problem is one of chicken and egg, in the sense that in order to have a liquid market a large volume is needed and in order to have a large market there must be a significant degree of liquidity.

Nevertheless, it is possible to break the circle, as demonstrated by the cases of Belgium, France and Spain, where securitization markets are new but where a liquid secondary market is well developed. The situation is not yet perfect, but the problem to date has not been that investors are disappointed; in fact, the investors who have bought these products have been so satisfied that they scarcely resell them. In the current market circumstances in Europe, it is much more difficult to find a secondary market seller than a buyer, which is very encouraging for investors, but which creates a problem of lack of supply to the secondary market from existing issues. The fact that new issues have tended to be sporadic and not characterized by a regular flow has meant that periods of reasonable liquidity in the secondary market are often followed by periods of drought when little new supply is available.

INVESTOR EDUCATION

Even though securitization transactions can be very interesting for investors, a securitized asset is not a simple product. A complete evaluation of the bonds issued in such a transaction requires a good understanding of the underlying loans and associated cash flows.

It is also necessary to evaluate the financial and legal structure of the vehicle and to assess the likely impact on the rating of the bonds of the different events which could occur with respect to either the participants or the loans themselves. This type of analysis is not necessary for the evaluation of most other more traditional financial products, and many investors are not accustomed to the need for it.

Our experience with developing new securitization markets in Europe (Belgium, France and Spain) shows that the sale of securitized products and the development of the primary and secondary markets both require a special effort to educate investors.

Even prior to this effort, there needs to be a comprehensive program to educate sales personnel and traders so that they can answer any question on the estimated cash flows of the bonds, as well as on the financial and legal structure of the transaction.

This preliminary educational phase of sales personnel, traders and investors is time consuming. It can, however, make the difference between an adequate investment capacity and thus a success for the issue or a situation in which the sale of the product of each transaction is enormously difficult, particularly after the novelty of the first issues wears off.

There is no one precise pattern or formula that must be followed for investor education. Rather, the process must involve the development of an agreed vocabulary, an understanding of the transaction's contractual structure and a level of confidence with respect to the sensitivity of the cash flows to changes in assumptions on prepayments, delinquencies and defaults. Usually, this process is most efficiently accomplished through individual meetings during which investors can asked detailed questions on various aspects of the transaction.

INFORMATION REQUIREMENTS

Asset securitization is a complex product. Investors need to receive a considerable amount of information in order to evaluate securitized assets and make a proper investment decision. The prospectus is the primary source of information for investors. However, unlike traditional bonds, securitized assets evolve over time, sometimes significantly.

Thus, it is necessary to keep investors informed of events which can affect the speed or security of their capital reimbursement. The regulatory authority generally establishes a minimum list of information to be supplied to investors, such as prepayment rates and default rates; but it is usually true that additional information is necessary to fully understand the product, and such information must be provided in order to promote the effective sale of the product.

In addition to the information provided in the prospectus when the issue is launched, the management company or lead managers should provide investors with simulations of cash flows on the loan portfolio with different assumptions on defaults and prepayments. Based on the simulated flows, investors can be informed of the sensitivity of price and yield to different assumptions on the underlying parameters.

Some investors wish to re-estimate for themselves the provisional cash flows, in which case current information on the loans is necessary. Such investors need to receive regular updates on the breakdown of the loan portfolio (by tranches of interest rates and remaining term) in order to recalculate their simulations.

VALUATION OF SECURITIZED PRODUCTS

Bonds issued in a securitization transaction are generally quoted on a stock exchange or other organized market. However, most secondary trades of securitized products are done on the basis of on-screen quotations transmitted by market makers specialized in the product.

The development of liquid secondary markets for securitized products in the new markets of Europe has been marked by several distinguishing characteristics. The secondary market has generally been organized by a few establishments which from the beginning have been interested in the market, have created specialized securitization teams and have trained traders and sales people.

These companies have developed the information systems necessary to evaluate and price securitized products, and so are able to give quotes on the secondary market. Historically, they have been the arrangers and lead managers of the transactions and have been involved as market makers for the securitized bonds. In general, price quotations have been published on Reuters pages: on the French market there are currently six to eight screens with pricing for the various bonds that have been issued. Fewer firms are active in the Spanish arid Belgian markets, but there are several Reuters screens showing prices in each market.

SECONDARY MARKET: CREATION OF LIQUIDITY

Securitization is still a young market outside the United States. In countries where the market has started to develop, volumes are still relatively small. Nevertheless, the secondary market in many countries is working quite efficiently; even though the number of issues is not numerous in France for example, securitized products have been traded actively since the beginning. As a general rule we have noted that the transactions which have been launched have tended to trade on average one-and-a-half times in the secondary market.

The main question remains: How to create liquidity for a new product in a market where there has never been a similar issue in the past? Although it should not be expected that the liquidity of a securitized asset will be the same as that of the market for more traditional bonds, there are several elements which can contribute to a situation where the lack of liquidity in absolute terms does not present serious problems for the establishment and development of the securitization market.

- Individual issues should be of a substantial amount so that the size of the issue itself will reassure investors that it will be liquid. We recommend a minimum amount of the equivalent of US$150-200 million for the first issue in a new market.

- The number of members of the underwriting syndicate should be kept small, and each member should guarantee the placement of an important amount of bonds. An engagement to support the secondary market should be requested as a counterparty to the invitation to participate in the syndicate.

- The lead managers should ensure the efficiency of the secondary market by establishing and supporting a small spread between the buy rate and the sell rate. This margin should be consistently maintained at a low level, say around 0.10% in prices.

- Securitized products from different issues should be structured similarly. It is easier for an investor to work on a series of similar operations than to have to undertake an entirely new legal and financial analysis for each new product with a different structure.

- An effort should be made to place at least some of the bonds with investors who intend to sell the bonds at some point, so as to sustain the level of supply in the secondary market during the early phases of market development.

CONCLUSION

To summarize, the secondary market for securitized products is not easy to develop during the early phases of a new geographical market. However, it is possible to follow a strategy which aims at reducing the negative effects resulting from the fact that the market is new. This strategy consists, in effect, to a commitment from the lead managers to reassure the investors, formally or informally, that they will be able, should they so decide, to sell their bonds at an acceptable price.