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Restarting Asset-Backed Securities and Current Developments in the Securitization of Financial Assets: The Case of the European Market

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Abstract

Since the inception of the 2007-2008 financial crisis, there has been increased interest on how to restart the Asset-Backed Securities (ABS) market especially in Europe. The crisis exposed several shortcomings in the securitization process which include inadequate due diligence on the part of investors, conflicts of interest and misaligned incentives among participants along the securitization chain, overreliance on rating agency risk models, and lack of transparency regarding collateral and deal structures. This paper therefore provides an insight into how ABS will be conducted in Europe after the recent financial crisis and highlights the current developments in the securitization of financial assets. The paper examined how the financial crisis of 2007-2008 has reshaped the business of ABS using data from the Association of Financial Markets in Europe (AFME) and European Securitization Forum (ESF) quarterly reports. A hypothesis was formulated and four research questions were answered with the help of secondary data. The hypothesis was tested using the student t-distribution and subjected to regression analysis. The data was analyzed with the use of Excel Analysis Toolpak and Pivot tables and charts. The results obtained showed that the financial crisis had a minimal impact on reshaping the ABS market. It was also observed that, ABS business after the crisis has mainly been reshaped by regulatory reforms.

Keywords: Securitization, Asset-Backed Securities, Financial Assets, Financial Crisis, European Market.

1. Introduction

Over the years, corporations have depended so much on bank loans for the operation and expansion of their businesses, just as banks have relied on savings for their liquidity. In recent times however, corporations have sought to find alternative ways of raising capital for their long-term sustainability and to decrease their overdependence on the crisis-prone banking sector. Likewise, Banks have been making efforts to find faster and cheaper means of raising capital, in order to remain liquid, meet the capital requirements of regulators, and also stay competitive. This has resulted in a number of innovations in financial and capital markets, hence the introduction of other sources of funding. One of such is the asset securitization market. This market offers a cheaper form of raising capital that is also considered to be timely. In such a market, companies (originators) seeking to raise capital are seen to be distinct from the originator´s assets that have been securitized. Thus, the quality of assets that have been securitized and issued becomes independent of the creditworthiness of the originator (Martin, 2009). Hence smaller companies, start-up businesses or corporations without higher ratings still have an opportunity to raise timely capital to support the growth of their firms. Securitization is also seen as a tool that results in the diversification of risk, thus serving as a risk management tool. Asset securitization occurs in one of three major forms as: Asset- Backed Securities (ABS); Mortgage Backed Securities (MBS); and Collateralized Debt Obligations (CBOs). Nonetheless, this paper focuses on ABS as much study in the past has concentrated on MBS and CBOs.

Securitization is said to have developed and grew faster in areas where there was a shortfall of capital supply (Kendall, 2000). It has been a solution in responding to a number of economic crises as well as financially distressed companies in the past. This is justified by the statement of Oberg (2010, p.1), 'In the S&L crisis, there were tangible assets at these financial institutions that were out of favor/under water: Mortgage whole loans, commercial real estate loans and high-yield bonds. Securitization was used as the takeout strategy. Securitization was the answer; securitization was the savior.' The assertion is also confirmed by Wheeler et al (2008) that the first non-agency securitization was carried out for distressed companies [such as Sperry (Unisys), Chrysler and International Harvester] that could not qualify to access bank loans.

However, securitization has been noted as one of the major causes of the recent financial crisis of 2007-2008 (Blommestein, Keskinler and Lucas, 2011; Oberg, 2010; Eggert, 2009; Martin, 2009). Securitization through the crisis resulted in the shortfall of capital supply, the very reason for its origins. Consequently, the growth of the market declined in 2007, and came to a near-collapse (Valdez and Molyneux, 2010). The 2007 financial crisis exposed several shortcomings in the securitization process which include inadequate due diligence on the part of investors, 'conflicts of interest and misaligned incentives among participants along the securitization chain, overreliance on rating agency risk models, and lack of transparency as regards collateral and deal structures' (ECB February 2011 report, p. 7). It is therefore necessary that these flaws be repaired as markets attempt to start securitization again. Furthermore, the asset securitization market has increasingly become complex and the complexities arising in the market need to be addressed; especially as economies recover from the recent crisis to avoid the occurrence of another crisis that will have potential long term effect on economies worldwide.

In the wake of the foregoing, this paper assesses how things will be done differently after the crisis, what lessons have been learnt that will reshape the securitization process and asset securitization market as a whole and what other developments are emerging in the securitization of financial assets. The paper further assesses the attractiveness of the ABS market to both originators and investors after the crisis as well as the risks associated with the market. The findings of this paper is useful for investors and originators of the ABS market and policy makers in their attempt to manage their risks whilst taking advantage of the superior returns offered by the securitization market. It is also helpful in the bid to restore confidence in the securitization market so that it remains an attractive market.

The rest of the paper is organized as follows: the next section explains some basic theory and reviews related literature. Section 3 highlights the materials and methods used in gathering, presenting and analyzing the data. The results are presented and discussed in section 4 and section 5 details the conclusions drawn.

2. Theory and Related Literature

2.1 *What is Securitization?*

Securitization has been defined differently by different authors. Prominent among them are the following: Gangwani (1998, p. 2) defines securitization as 'the pooling of "homogenous," "financial," "cash flow producing," "illiquid" assets and issuing claims on those assets in the form of marketable securities'. A different definition given by Cowan (2003, p. 1) describes securitization as 'the creation and issuance of debt securities, or bonds, whose payments of principal and interest derive from cash flows generated by separate pools of assets'. On the other hand, Fabozzi and Kothari (2007, p. 3) offer a more detailed explanation of securitization. In their opinion, securitization is understood today 'to mean a process by which an entity pools together its interest in identifiable future cash flows, transfers the claims on those future cash flows to another entity that is specifically created for the sole purpose of holding those financial claims, and then utilizes those future cash flows to pay off investors over time, either with or without credit support from a source other than the cash flows'. However, Baums and Wymeersch (1996) argue that the above definitions focus on the process of securitization and not on its meaning or substance. Hence, they offer the following definition: 'securitization consists of the use of superior knowledge about the expected financial behavior of particular assets, as opposed to knowledge about the expected financial behavior of the originator of the chosen assets, with the help of a structure to finance the assets more efficiently'. According to them, the definition is superior because it explains the most essential aspects of any securitization within any legal framework worldwide. In simple terms however, securitization can be said to be a process of making assets that otherwise are considered illiquid into liquid assets in the form of securities that are sold to investors.

2.2 Securitization Process

According to Leixner (2006, 2007), the securitization process in its simplest form involves the sale of a pool of assets by an entity (financial or non-financial corporations, government entities) known as the originator to a Special Purpose Entity/Vehicle (SPE or SPV) that is supposed to be "bankruptcy remote" and then the issuance and sale of these assets by the SPV to investors through a private placement or public offering. According to him, the sale of the assets by the originator to the SPV must be done in a manner that qualifies as a "true sale" as against a secured loan. After the securitization, funds then flow from the purchasers of the securities first to the SPV who are the issuers and then from the SPV to the originator.

A true sale in the opinion of Fabozzi and Choudhry (2004) implies that there is a legal separation of assets from the originator of the assets. Consequently, no creditor of the originator can make claims on those assets in a case of the originator´s bankruptcy. The true sale thus results in the absolute transfer of the sold assets and their related risks and benefits from the originator to the SPV. In addition, the bankruptcy remoteness inherent in the asset securitization process makes the SPV independent of the originator such that the bankruptcy of the originator has no effect on the SPV and eventually the assets. Thus, in the views of Fabozzi and Choudhry (2004), the SPV is not bankruptcy-proof entity and has limited risk of voluntary or involuntary bankruptcy filing. Therefore, the true sale and bankruptcy remoteness concepts of securitization protect investors from being exposed to any credit deterioration or bankruptcy of the originator. This forms the basic distinction between ABS and unsecured debt and one of the major attractions of investors to the ABS market. It also demonstrates the logic behind the originate-to-distribute model of securitization as against originate-and-hold model. The latter is the traditional approach of funding credit whereby lenders find borrowers, originate loans and then hold such loans on their balance sheet until maturity. On the other hand, the former, which is termed the securitization approach, involves lenders finding borrowers, originating loans and instead selling these loans (repackaged as securities) to investors (Valdez and Molyneux, 2010). Figure 1 below shows how an ABS security is created.

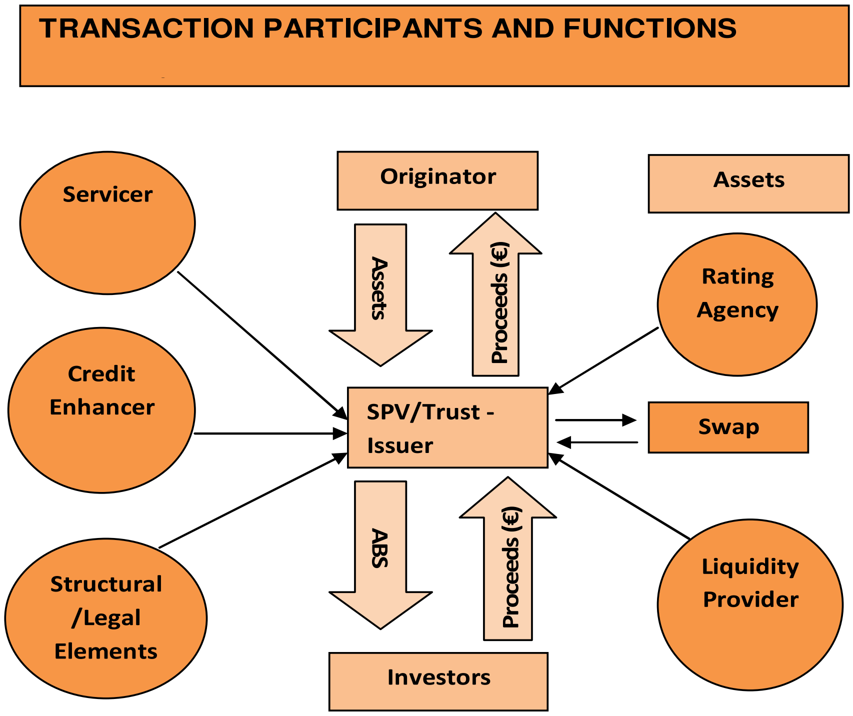

Figure 1: Creation of an ABS security

Source: Adopted from European Securitization Resource Guide and Merrill Lynch in: Fabozzi and Choudhry (2004), The Handbook of European Structured Financial Products.

Exhibit 1.0 in the appendix briefly explains the key parties of ABS as shown in figure 1 above. However, credit enhancements and rating agencies are elaborated below.

2.2.1 Credit Enhancements and Rating Agencies

An important feature of the securitization process is the credit enhancements of the assets by rating agencies. These enhancements help the assets attain higher ratings, thereby making them more attractive and marketable to investors. Additionally, credit enhancements afford issuers the ability to market their securities at lower interest costs. In the view of Fabozzi and Choudhry (2004, p. 33), credit enhancement is the 'cushion put in place to protect investors against expected losses'. The type of credit enhancement obtained depends on a number of factors. These include the characteristics of the securitized assets, the requirements of the rating agencies, the goals of the securitization sponsor and the size of enhancement needed. The function of the rating agencies is to size the credit enhancement needed for the asset pool to attain the desired ratings. The enhancement is sized such that it reflects the level of expected loss. Thus, the type of credit enhancement determines the classification of assets as senior, mezzanine or equity tranches. The rating agencies estimate the expected loss using a series of scenarios or worst cases that could result in the lifecycle of the asset pool. Therefore, the credit enhancement is meant to address all forms of adverse eventualities that have the potential to affect the asset pool during its life. Consequently, the major role of ratings is to help investors make investment decisions. Ratings also protect investors from taking unknowing credit risks as 'ratings set a defined credit standard that investors understand and accept' (Fabozzi & Choudhry 2004, p. 83).

2.3 Securitization and the Financial Crisis of 2007

The American subprime meltdown has been the main catalyst for the financial crisis of 2007-2008. The subprime crisis started in late 2006 when the value of property was decreasing and was no longer worth the mortgages to be paid for them. This brought about lots of defaults by subprime borrowers as they could not afford to pay their home mortgages. This resulted into increasing default on subprime loans and thereby made a number of subprime lenders go out of business (Eggert, 2009). Consequently, investors were not purchasing securities backed by subprime loans as well as financial institutions losing trust in each other and finally resulting to the credit crunch. According to Eggert (2009), the subprime meltdown was caused in large part by securitization. In his opinion, subprime lenders via securitization were able to make loans and sell them in Wall Street, where securities backed by subprime loans were marketed by investment houses. This allowed subprime lenders to quickly unload much of the risk associated with the subprime loans as well as recoup the money lent and thereby relending it to new subprime borrowers. This assertion is shared by Buiter (2007) who argued that one of the major microeconomic causes of the financial crisis has been securitization. He suggests that securitization increased the risk appetite of investors resulting into originators originating more risky ABS without assessing the quality of the assets and thereby resulting in the great meltdown.

3. Materials and Methods

3.1 Study Area

This paper was based on the European market, the second largest securitization market worldwide. The European market here refers to all countries of the European Union that engage actively in the asset securitization market. The earliest known securitization in Europe and worldwide took place in Denmark, where mortgage bonds were used to finance the purchase of houses many years before it became widely used in the US in the 1970s (Levinson, 2009). The first issuance of assets backed by securities within the European region is said to have taken place in the UK in 1987, which is currently the largest securitization market in Europe (Angheben, 2007; Taylor, 1996). The dominant asset class is UK RMBS, which represents about 50% in terms of value of the volume of Issuance. Dutch RMBS is also becoming very popular. According to a recent European Central Bank report (2011), the main issuers of securitized products in Europe are the United Kingdom, the Netherlands, Spain and Italy. There has been an increasing trend in the European securitization market since its inception. The investors of the market are both institutional and retail. The institutional investors are mostly banks, insurance companies, hedge funds, asset managers, pension funds and private banks (Angheben, 2007). An important feature of the European Securitization market is its investor base, which is uniquely dominated by Structured Investment Vehicles (SIVs); securities arbitrage conduits and money market funds (Rajendra, 2008). The securitization market in Europe is regulated by both individual country regulators as well as European Union wide legislation. This makes the situation of the market quite complex as legal laws differ widely across the countries (Baums and Wymeersch, 1996). Therefore, the difference in Country regulation has been a determinant for the growth of the market in the various countries.

3.2 Methods

This paper made use of Secondary data available from the quarterly reports of the Association of Financial Markets in Europe (AFME) and the European Securitization Forum (ESF). The target population of the paper was the total volume of ABS issuance (both retained and newly placed) in the European market before and after the financial crisis. The sample is made up of total ABS issuance 2 ½ years prior to and 2 ½ years after the crisis. That is Q4 2004 – Q1 2007 and Q4 2008 – Q1 2011 making a total sample of 20 quarters over a five year period. 20 quarters was chosen as the sample size because the period after the crisis is 10 quarters and to allow for easy and accurate comparison of the situation before and after, 10 quarters had to be taken for the situation before as well. Non-probability sampling methods namely quota and purposive sampling have been used to determine the sample. Two quotas as BEFORE and AFTER the crisis of 2007-2008 were identified. Using purposive sampling, the researcher handpicked equal sample size from each quota. The data was analyzed using: a) Tables and charts, b) Student´s t distribution, c) Pearson correlation and d) Regression analysis. The data was then subjected to regression and correlation analysis to determine the extent of relationship between the situations before and after the financial crisis.

3.3 Assumptions of the Study

The following assumptions have been made in this paper:

1. The recent financial crisis started in the second quarter of 2007 and lasted till the end of the 3rd quarter of 2008 (lasted one and a half years).
2. Changes in volume of ABS issuance is a factor for determining if the financial crisis has reshaped the business of ABS
3. Changes in volume of new issuance are factors that determine whether the market remains attractive to originators and investors.
4. Credit ratings upgrades or downgrades before or after the crisis is a determinant of whether the financial crisis has reshaped the business of ABS
5. Regulations before and after the crisis is a deterministic factor of the impact of the crisis on the asset securitization business
6. Investors rely on credit ratings to determine the risk associated with the asset securitization market
7. The behavior of ABS is parallel to that of the general asset Securitization market.

4. Results and Discussions

4.1 Hypothesis Test

Null Hypothesis: The financial crisis of 2007-2008 has not reshaped the business of asset-backed securities.
Alternative Hypothesis: The financial crisis of 2007-2008 has reshaped the business of asset-backed securities.
According to Barrow (2009), the null hypothesis is rejected if either of the two methods below is true.
Method 1: The test statistic is greater than the critical value, i.e. t> t*, or
Method 2: The Prob-Value associated with the test statistic is less than the significance level, i.e. P<0.05 (if the 5% significance level is used).

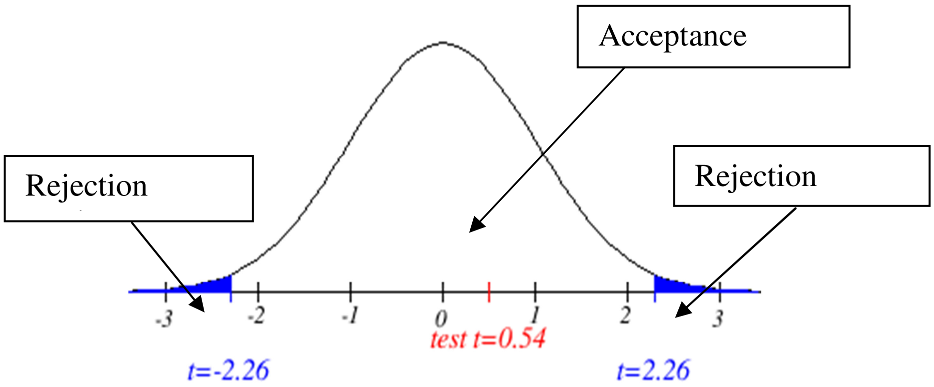

Figure 2: Student t Distribution for the Hypothesis

It can be seen in figure 2 above that the t statistic value falls within the acceptance region because 0.54 is not greater than the t critical two-tail value of 2.26. Therefore, with 95% certainty, it is concluded that the null hypothesis cannot be rejected. This implies that the financial crisis of 2007-2008 has not reshaped the business of asset-backed securities. A weak positive correlation between the BEFORE and AFTER ABS volume of Issuance was also observed. Thus, the strength of association between the two variables is weak and therefore not significant. The Pearson correlation coefficient shows only the degree of association among the variables and not causality. Hence, a regression analysis was done to determine the cause-effect relationship (see table 1 below). The R Square (R^2) of 0.23 means that only 23% of the variation in the ABS volume of issuance (AFTER) is explained by the financial crisis. The 77% that is unexplained could be the result of the omission of relevant variables or multi-culinearity. The degree of variation is also not strong at a significance F of 0.16 (16%), indicating a greater probability that the output of the regression is not by chance.

Table 1: Regression Analysis Summary Output

Regression Statistics								
Multiple R	0,4784027							
R Square	0,2288692							
Adjusted R Square	0,1324778		y= 9,07 + 0,31x					
Standard Error	9,134439							
Observations	10							
ANOVA								
	df	*SS*	*MS*	*F*	*Significance F*			
Regression	1	198,112985	198,11	2,3744	0,161908999			
Residual	8	667,503803	83,438					
Total	9	865,616787						
	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95,0%*	*Upper 95,0%*
Intercept	9,0719369	4,45412205	2,0368	0,0761	-1,199286905	19,3431608	-1,199286905	19,3431608
X Variable 1	0,3149128	0,20436935	1,5409	0,1619	-0,156363736	0,7861894	-0,156363736	0,7861894

Although the hypothesis test does not reject the null hypothesis, the crisis indeed did bring about a decreasing trend in the issuance of ABS as shown in figure 3 below. Also, the causality determined through the regression analysis is a proof of effect of the financial crisis on the ABS business. Besides, most financial commentators have argued that the ABS market has seen some changes since the financial crisis. The major element of change has been that of regulatory reforms. These reforms are discussed in the upcoming pages. It can thus be argued that the hypothesis test is not a true reflection because the sample size is small. This argument is justified by the statement of Barrow (2009, p. 195) that `if a large enough sample is taken the null hypothesis is almost certain to be rejected, because there is bound to have been some change, however, small'.

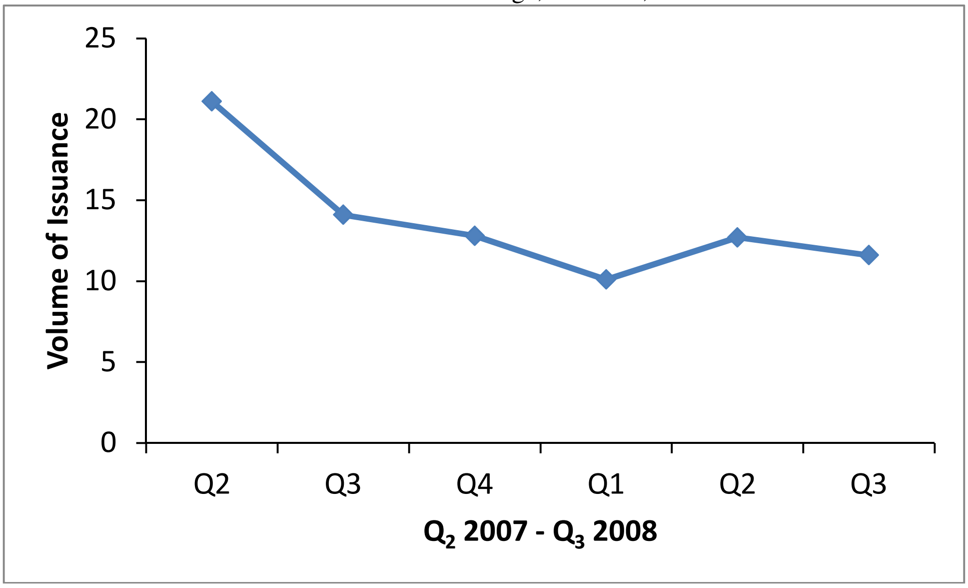

Figure 3: European ABS Issuance during the Financial Crisis in EUR bn

4.2 New Regulatory Framework of the Securitizations Market

Risk Retention Rules

One of the major regulatory reforms to securitization after the financial crisis is the amendment of the Capital Requirements Directive (CRD). Article 122a of the CRD, which came into effect in January 2011 requires that originators or sponsors (credit institutions) retain not less than 5% net economic interest in the assets they securitize on an ongoing basis (CEBS Guidelines). It also requires the disclosure of the level of commitment to investors (paragraph 7) and the demonstration of a comprehensive and thorough understanding of securitization positions to competent authorities (paragraph 4). The non-compliance of this directive is subject to capital penalty. Although the directive allows for risk sharing between originators and investors, it could also impose higher administrative costs on originators. The impact of the directive to some extent might not be great as most originators already retain the equity tranches which are the highest risk bearing asset class.

Basel III Liquidity Requirements

The Basel III banking regulation proposes the exclusion of asset-backed securities from the list of securities that are eligible for the calculation of the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) (Blommestein, Keskinler and Lucas, 2011). The proposal is aimed at ensuring the liquidity of credit institutions and investment firms as well as strengthening resilience of the European banking system. This proposal though good has the potential to deter banks from engaging in the ABS market. The effect would be the reduction in the ABS investor base as banks have constituted the majority of investors.

Credit Rating Agency Reforms

Credit Rating Agencies (CRAs) have been largely accused of fueling the crisis of 2007-2008. Prior to the crisis, CRAs underestimated the risks of complex securitized products and did not also act promptly to market changes. For this reason, the European Parliament and Council approved a regulation for CRAs in April 2009 which was strongly supported by the European Commission.[1] The fundamental goal of the regulation is to avoid the existing and potential conflict of interest between CRAs and the organizations they rate. The key issues addressed in the regulation include; registration and supervision of CRAs; CRA internal governance; disclosure and transparency obligations; quality of rating; and independence and avoidance of conflicts of interest.[2]

In as much as regulation is needed for the resurgence of the ABS market, it might also hinder the market's recovery with a number of uncertainties or regulation still pending for legislation. For instance, the CRD4 which is the proposed legislation for the enforcement of the Basel III is yet to come into effect.

4.3 Other Issues of the Securitizations Market after the Crisis

[1] Europa Press Release, 23.04.2009.
[2] Commission of the European Communities Proposal for regulating credit rating agencies.

4.3.1 Attractiveness of the ABS market to investors and originators after the financial crisis.

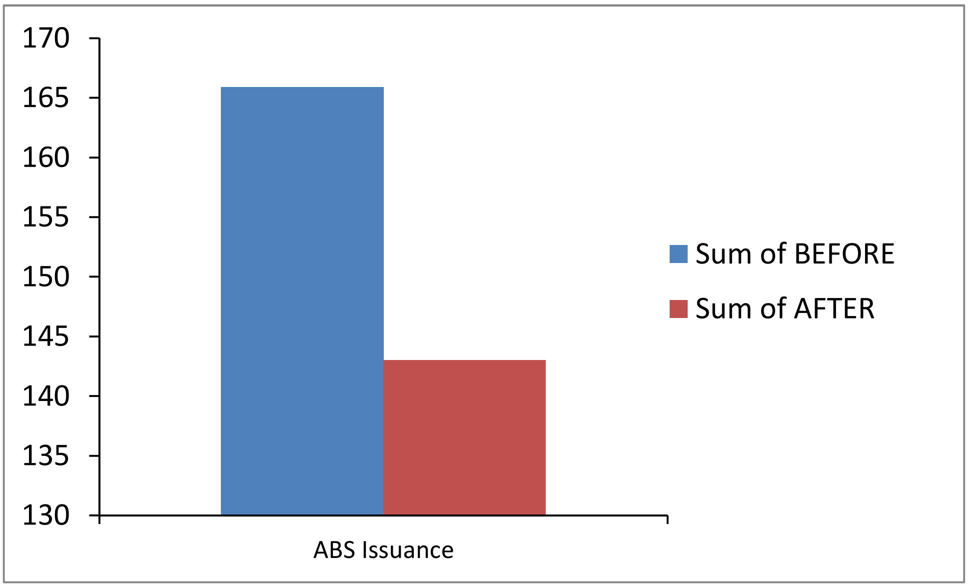

Figure 4: European ABS Issuance Before and After the Financial Crisis, EUR bn

Considering the decrease in volume of issuance (as shown in figure 4 above), the market can be said to be unattractive to both investors and originators. This can be attributed to the low demand for the ABS products due to the loss of investor confidence hence, the short supply. Another explanatory factor for the fall in demand of ABS is the limitation of the involvement of banks as investors through regulatory reforms as banks used to form a major component of the investor base.

Looking at the fluctuating but mostly decreasing ABS spread (using Auto and credit card as examples) as shown in figure 5 below, securitization cannot be said to make any economic sense to originators especially when the very recent spreads are considered. Hence, the ABS market does not appear attractive to originators.

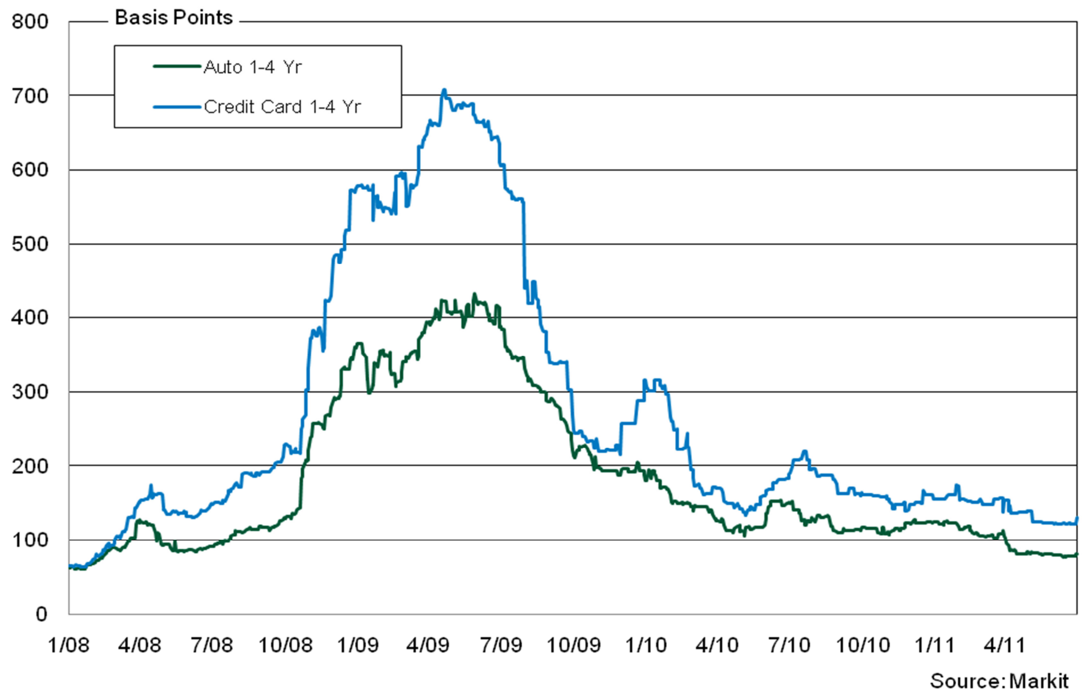

Figure 5: European 1-4 Yr AAA ABS Spreads

Nevertheless, originators to a large extent, still find the market attractive as they use the issuance (retained) as collateral with the ECB. Consequently, a new model of ABS known as the originate-to-repo[3] model has emerged. Although, that was not the initial purpose of ABS, the shift from the originate-to-distribute model still offers the market originators an advantage (The true picture of the situation is presented in figure 6 below). Therefore, the purpose of the market can be said to be expanding or evolving in a positive way. The shift also brings to light the important role being played by the ECB as the provider of liquidity to the European banking system. However, it is worth noting that the use of the retained issuance as collateral in itself cannot offer a sustainable strategy to the ABS market in the long term, but when used in combination with the originate-to-distribute model, it could present a new market strategy that has the potential to ensure the long term sustainability of the market. It can be seen from figure 6 below that the placed issuances are very much below 50% of the total volume. This justifies the conclusion that the securitization market is no longer attractive to investors and originators after the financial crisis. On the other hand, the conclusion that the market remains attractive to originators through the retained issuance is affirmed as the retained issuance constitute about more than 70% of the total volume. These conclusions are valid for ABS on the assumption that the ABS market is parallel to the entire securitization trends.

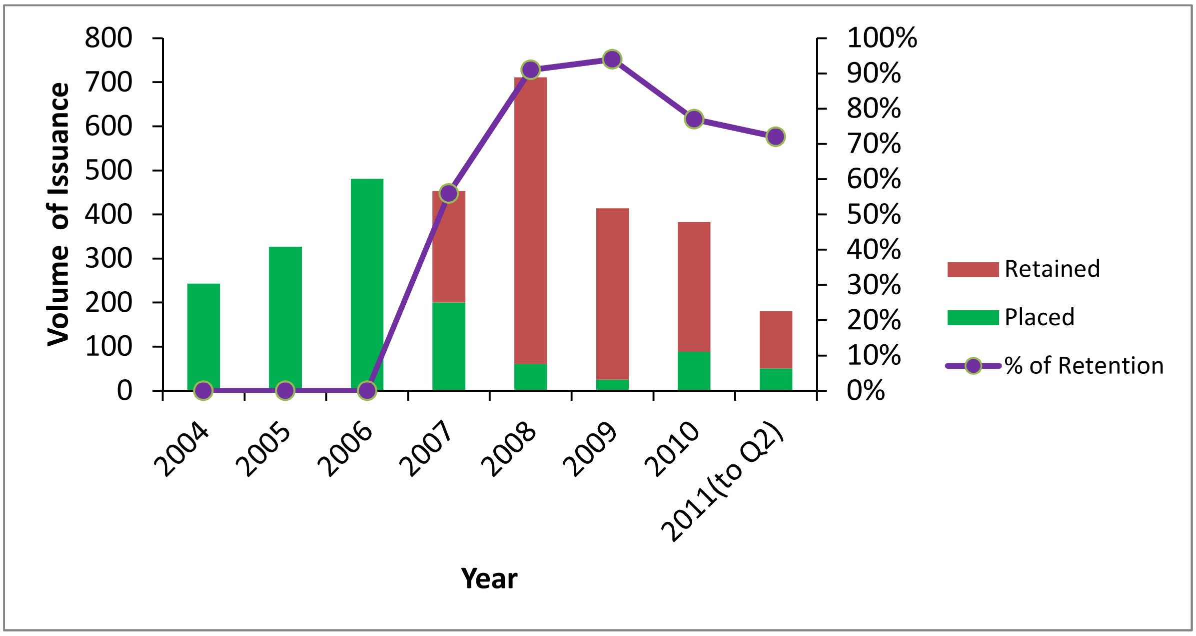

Figure 6: European Securitization Issuance 2004 -2011 EUR bn

4.3.2 Assessment of Risk by Investors

Investors of the ABS market assess their risk using credit ratings and investor reports. The most common assessment indicator is the credit ratings provided by rating agencies. Credit rating agencies in the ABS market establish the needed credit enhancements for the assets to be securitized which ultimately determines the credit quality of the assets. There exist different ratings as AAA, AA, BBB, BB, etc. The type of rating an asset pool has, determines its tranche classification as senior, mezzanine or equity. These ratings make it easier for investors to make investment decisions based on their risk appetite which is reflected in the tranche of assets they invest in. However, most investors have lost confidence in the credit ratings after the financial crisis and following the collapse or bankruptcy of companies with good ratings at their time of liquidation. Investors have also been blamed for relying solely on credit ratings to determine their risk. However, the studies of Vink and Fabozzi (2009) claim that the statement of investors overreliance on ratings is overstated. They suggest that in spite of the heavy reliance of investors on ratings, they also do not ignore other credit related factors. Another way investors assess their risk in the ABS market is through investor reports provided by originators or issuers. These are mostly periodical reports that include the performance of assets together with the ratings.

4.3.3 Current Developments in the Securitization of Financial Assets

In recent times, a number of developments have emerged in the securitization market. A major current development is the use of ABS as collateral with the Eurosystem (ECB, 2011). With the outbreak of the financial crisis, senior tranches of securitized products have been used as collateral with the ECB Eurosystem. The composition of collateral posted with the Eurosystem now has ABS as the largest single asset class (see figure 7 below). For instance, the average share of ABS rose from 11% in 2006 to 28% in 2008 but decreased slightly to

[3] José Manuel González-Páramo, keynote speech at AFME/ESF and IMN Global ABS Conference 2010.

24% in the first three quarters of 2010 (see figure 8 below)[4]. This development has provided an added incentive for banks to engage in the securitization market. As a result, helping to ease funding problems in the EU as well as make the securitization market attractive to bank originators in the wake of the crisis. The upward trend in the share of ABS Eurosytem collateral may also reflect the real ongoing turbulence in the financial market. Additionally, it shows that counterparties are using more of less liquid assets with the Eurosystem whilst the more liquid assets are kept for the private repo and interbank markets. This argument is further complemented with the decrease in the usage of central government securities from about 21% in 2006 to about 12% in 2009 and 2010 (ECB, Euro Money Market Study, December 2010).

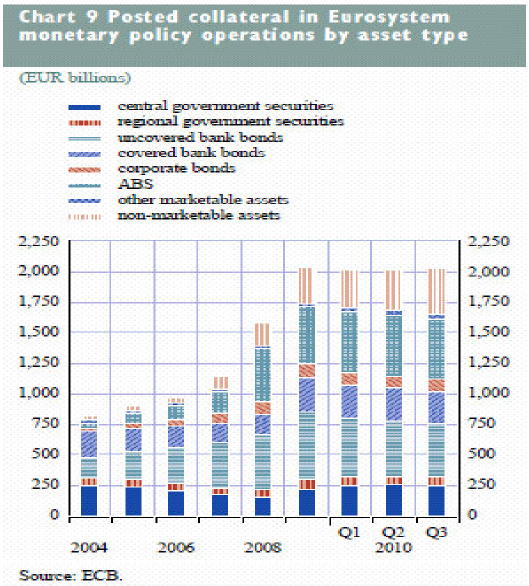

Figure 7: Collateral Posted with **the ECB**

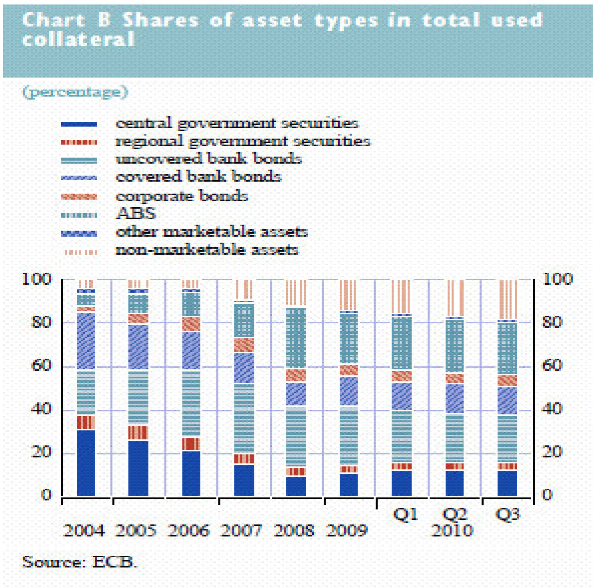

Figure 8: Eurosystem by Asset Type

Another developing phenomenon in the securitization market since the crisis has been the rating downgrades as shown in figure 9 below. Most changes in ratings have been downgrades with little upgrades. For example, about 43 out of the 62 European CMBSs were downgraded by S&P in the fourth quarter of 2009. At the same time, Moody's also downgraded around 63% of CMBS tranches that it rates whilst upgrading only 1% (ECB, 2011). These downgrades could be attributed to changes in rating methodology and poor collateral performance. The main reasons for the downgrades have been summarized in exhibit 2 in appendix. It is worth noting that the causes of the downgrades have been different for the various asset classes. For instance, the RMBS downgrades have been the result of weak performance whilst the downgrades in ABS stems mostly from changes in rating methodology. Most of the bigger rating agencies such as S&P, Moody´s and Fitch have changed their rating methodologies to address issues relating to underestimated risk factors which includes concentration and correlation risk.

[4] ECB, Euro Money Market Study, December 2010.

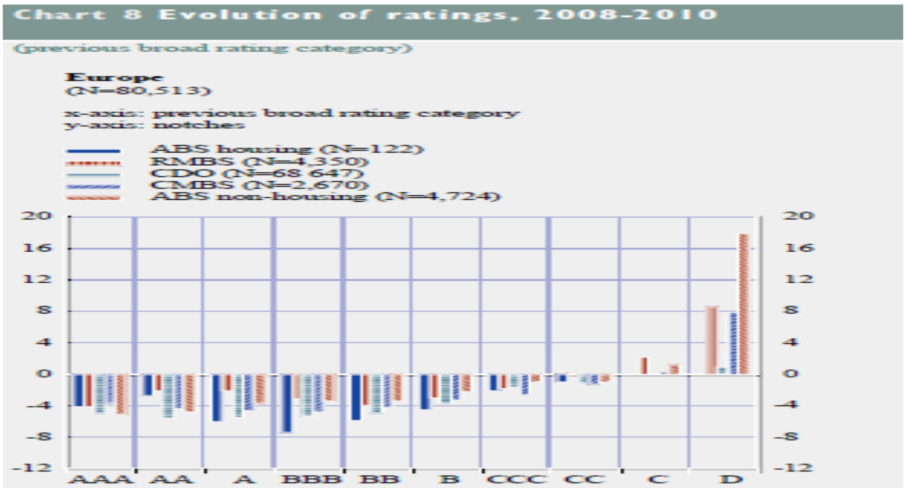

Figure 9: Evolution of Ratings, 2008-2010

Furthermore, covered bonds are becoming a very important source of funding in recent years. The increasing importance of covered bonds is attributable to the favourable treatment for liquidity from regulatory side, the shortcomings of securitization as exposed by the crisis and because they provide investors with protection. The two main protections that covered bonds offer to investors are: first, the recourse to the underlying assets (mostly made up of good quality instruments that offer a sufficient amount of overcollateralization) and second, is the issuing bank´s other unsecured assets (ECB, 2011). Besides the above, the purchase of covered bonds by the Eurosystem through its covered bond purchase program has been an added advantage of covered bonds becoming attractive. For instance, covered bonds regained its strength after the announcement of the ECB's covered bond purchase program in May 2009 as shown in figure 10 below. Additionally, the introduction of national legislation by a number of countries (such as the Netherlands and Greece) within the European region where such laws did not previously exist coupled with revision of some national legislation (like Portugal) has made covered bonds more desirable (ECB, 2011). Finally the ability of covered bonds through its double-guarantee schemes to address the increase in the pricing of credit risk of banks has also contributed to its importance (ECB, 2011).

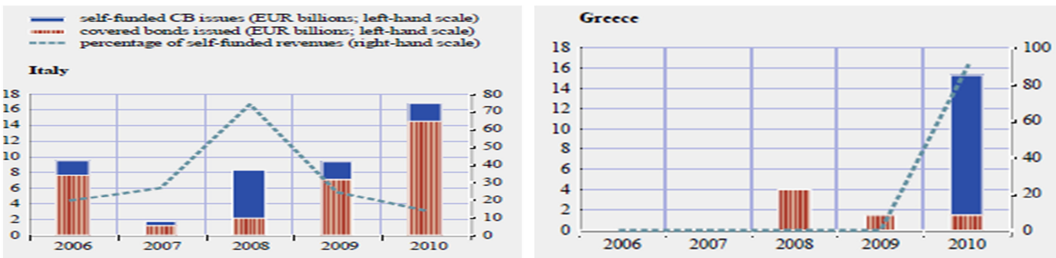

Figure 10: Covered Bonds Issued by Year and Country

Source: Dealogic as found in ECB February 2011 Report

Another development in the securitization market worth mentioning is the impact of sovereign risk on covered bonds and securitization as a whole. Sovereign risk is affecting the securitization and covered bonds market. As a result, only countries with less sovereign risk and relatively robust economic conditions (such as Germany, UK, Netherlands and Italy) have carried out securitizations. On the other hand, countries with lower sovereign ratings have remained much quieter and associated with low levels of issuance (ECB, 2011).

Other developments include the demand for simpler structures with high quality collateral by investors (Blumenstein et al., 2011). Investors are no longer interested in the complex structures but ones that are simple to be understood and have good quality. Hence, reputation as high quality originator is becoming a key determining factor for investors. Consequently, the current demand is focused on senior tranches as they have higher quality (ECB, 2011). Finally, the market is becoming overly dependent on both central bank and government support.

4.3.4 Elements to be considered in restarting the ABS market?

To restart the ABS market for longer term viability, the following comments must be carefully considered:

- Creation of simple and transparent products: the complexity of assets securitized had been a major issue culminating to the financial crisis. In this respect, originators and issues must create simple products that are transparent and easily understood by all market participants.

- Restore Investor Confidence: the weak confidence of investors that erupted after the financial crisis must be restored as the survival of the market is highly dependent on a confident and strong investor base.
- Focus on Asset Quality: It is necessary that investors focus on the quality of assets when making investment decisions. Much emphasis should therefore be placed on having good asset quality.
- Strong Disclosure Requirements: originators must disclose all information relating to the underlying assets to the investors. This should range from quality of the assets to its likely risk exposures. The documentation must be accurate.
- Investors must reduce their overreliance on credit ratings and use other methods to assess their risk on their own. To this end, it's also necessary that rating agencies act in a manner that they can gain back confidence in their credit ratings.
- Due diligence must be done throughout the securitization process to allow for careful scrutiny irrespective of how slow the process might be.

5. Conclusions

This paper sought to determine how the business of ABS will be carried out after the financial crisis of 2007-2008 and to bring to bear the current developments in the securitization of financial assets. The documentary search revealed a number of reasons and or benefits derived from the use of securitization for issuers, originators, investors and an economy as a whole. These benefits revolve around three key elements such as risk reduction, alternative source of funding and improvement of financial performance. Some challenges are however encountered as well. The result of the hypothesis test which has been a significant contribution of this study digresses from the opinion of most ABS market commentators. The market participants are of the view that the financial crisis has reshaped the business of ABS especially with regards to regulation but the hypothesis test proves otherwise. A number of developments are emerging in the market coupled with the fact that the market must be restarted with key issues of restoring confidence, increasing investor base and creating simple products in mind. The conclusions that can be drawn from the study are:

- Securitization grew rapidly in areas/markets where there was a shortfall of capital.
- Asset Securitization has been one of the major causes of the recent financial crisis of 2007-2008.
- The financial crisis of 2007-2008 has reshaped the business of ABS as found in the secondary literature. The policies to reshape the market of ABS have been mostly regulatory reforms. These reforms have covered issues relating to the key participants of the markets such as originators, investors and rating agencies.
- Investors heavily depend on ratings to assess their risk exposures in the ABS Market.
- The confidence in the ABS market is still weak in spite of the many efforts being made to revamp the market.
- Originators are using retained issuance as collateral with the ECB, resulting into the emergence of a new model of securitization called the originate-to-repo model. This Implies that the ABS market is evolving in a positive manner.
- ABS market is currently dependent on government support.
- Investors are more risk-averse and now favour simplified but quality ABS products.
- The market is evolving and will continue to expand to include a wide range of asset classes.
- Issuers must not be allowed to choose their own rating agency for the credit enhancements of their pools of assets. In this regard, an intermediary between issuers and rating agencies should be put in place such that there will exist a kind of clearing house or platform whereby the issuer is charged a fee based on the type of assets, maturity and complexity, and risk: and then the regulator get a rating agency to do the rating instead of the issuer finding the rating agency themselves
- It is necessary to put in place a central policy group handling all issues of the market on a global basis as a whole. Standardization or degree of convergence among different countries within the EU is needed.
- There is the need to attract a new investor base to add to the existing investors and to increase the demand for securitized products without government interventions. In this respect, it is recommended that a study is undertaken on how to increase the investor base.

Appendix

Exhibit 1: Key Parties to ABS/MBS Financing

- Assets Originator
  Entity with funding needs and with assets which can be used as collateral for ABS/MBS funding.
- Issuer of ABS/MBS
  Entity specifically created for the purpose of the Securitization – Special Purpose Vehicle (SPV) or Special Purpose Company (SPC).
- Outside Credit Enhancer
  Entity providing credit enhancement through insurance, guarantee, or reserve account.
- Servicer
  Entity which collects and distributes the cash flows from the assets
- Liquidity Provider
  Entity that addresses the timing mismatches between the collected cash flows from the assets and the cash flows to be distributed under the structured bonds.
- Rating Agencies
  Determine the credit strength of an ABS and size the credit enhancement level necessary to achieve that credit strength.

Source: Merrill Lynch in: Fabozzi and Choudhry (2004), The Handbook of European Structured Financial Products.

Exhibit 2: Main Reasons for Rating Downgrades

Main reasons for downgrades

(in percentages)

	RMBSs	ABSs	Total
Weak performance	76	44	64
Counterparty risk	9	16	12
Methodology	4	30	14
Sovereign risk	8	5	7
Monoline	2	2	2
Other	0	2	1

Source: Moody's.

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