Fixed Income

Asset-Backed Security (ABS) Instrument and Market Features

Exam Focus

- Covered bonds
- Credit enhancement
- Nonmortgage ABSs
- Collateralized debt obligations

Covered Bonds

- Senior debt obligations similar to ABSs, but no SPE is created
- Underlying assets remain on balance sheet of issuing corporation
- If mortgage borrower defaults, investors in covered bonds have **dual recourse** on the cover pool (i.e., the properties) and other assets of the issuers
- Generally lower yield than comparable ABSs

Covered Bond Provisions

- Hard-bullet covered bond
- Soft-bullet covered bond
- Conditional pass-through covered bond

Covered Bond Term Sheet: Example

Issue of EUR30 Million 2.00% Prospectus Summary	
Issuer:	Commercial Finance Partners AG
Issue size:	EUR30,000,000
Tranche size:	EUR30,000,000
Interest rate:	2.00%, payable annually on June 30
Settlement date:	[T + 3 business days]
Maturity date:	[20 years from settlement date]
The collateral:	Security in a pool of prime, fully amortizing mortgages
LTV cutoff:	80%
Format:	Soft bullet

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Covered Bonds: Example

Which of the following statements about covered bonds is correct?

A. Covered bonds have a single recourse nature.

B. Covered bonds have lower credit risk and offer lower yields than otherwise similar ABS.

C. Covered bonds are removed from the issuer's balance sheet and are ringfenced into a separate cover pool.

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Source: CFA Institute. Used with permission.

Credit Enhancement Structures

Internal: built into structure of bond issue

- **Overcollateralization:** collateral value is greater than amount borrowed
- **Excess spread:** yield on asset pool is greater than yield of bonds issued
- **Credit tranching/subordination:** different priority of claims for different bond classes, waterfall structure

Credit Enhancement

External:

Bank guarantee—issued by bank

Surety bond—insurance company

Letter of credit—financial institution

Provided by third party

Counterparty risk

Cash collateral account: cash borrowed by issuer; invested in low-risk, short-term debt securities at inception

Credit Enhancement: Example

The external credit enhancement that has the *least* amount of third-party risk is a:

A. surety bond.

B. letter of credit.

C. cash collateral account.

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Source: CFA Institute. Used with permission.

Credit Tranching: Example

Which of the following statements about credit tranching is *incorrect*?

A. The waterfall structure redistributes the credit risk associated with the underlying collateral.

B. Some of the bond classes may have a better credit rating than the company that is seeking to raise funds.

C. Risk ratings are based on the market risk of the pool of securitized loans or receivables as well as the priority of how they absorb losses.

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Credit Card ABSs

- Backed by pools of credit card debt owed to banks, retailers, etc.
  - **Cash flows:** repayments; interest; membership and late payment fees
  - Often includes lockout period
  - Any principal repaid during this time is used to purchase additional credit card receivables
  - After lockout period, principal payments are passed to investors

Credit Card Securitization: Example

Which of the following statements about credit card securitization is correct?

A. Additional fee income is generated for the issuer.

B. The credit card receivables are kept on the issuer's balance sheet.

C. The cost of default risk from credit card debt to the issuer increases.

Solar ABSs

- Backed by loans to homeowners installing solar energy systems
  - Attractive to ESG investors
  - Secured on asset itself or homeowner's property as a junior mortgage
  - Credit enhancement structures common to reduce risk to investor
  - Pre-funding period common, where funds are raised through issuing ABS before loans are made to homeowners

Collateralized Debt Obligations

- Security issued by SPE for which the collateral is a pool of debt obligations
- If collateral is corporate and emerging market debt = **CBOs**
- If collateral is leveraged bank loans = **CLOs**

- Do not rely solely on payments from collateral pool to meet obligations; instead, have a collateral manager who buys or sells securities in collateral pool to generate the cash needed

Collateralized Loan Obligations

- There are three main types of CLOs:
  1. Cash flow CLOs
  2. Market value CLOs
  3. Synthetic CLOs

Collateralized Loan Obligations: Example

Which of the following statements about collateralized loan obligations (CLOs) is incorrect?

A. Recourse is limited to the collateral pool, with minimal recourse to the original issuers.

B. Investors in senior or mezzanine bond classes typically earn a lower yield than comparable corporate bonds.

C. After the ramp-up period, the collateral manager may replace loans in the portfolio as long as the new asset meets the portfolio selection criteria.

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Solutions

Covered Bonds: Example

Which of the following statements about covered bonds is correct?

A. Covered bonds have a single recourse nature. *Covered bonds have a dual recourse nature.*

B. Covered bonds have lower credit risk and offer lower yields than otherwise similar ABS.

C. Covered bonds are removed from the issuer's balance sheet and are ringfenced into a separate cover pool. *Loans remain on the issuer's balance sheet and are ringfenced into a separate cover pool.*

Covered bonds have remained a relatively stable and reliable source of funding over time because of their dual recourse nature, strict eligibility criteria, dynamic cover pool, and redemption regimes in the event of sponsor default. As a result, covered bonds usually carry lower credit risks and offer lower yields than otherwise-similar ABS.

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Credit Tranching: Example

Which of the following statements about credit tranching is *incorrect*?

A. The waterfall structure redistributes the credit risk associated with the underlying collateral.

B. Some of the bond classes may have a better credit rating than the company that is seeking to raise funds.

C. Risk ratings are based on the market risk of the pool of securitized loans or receivables as well as the priority of how they absorb losses.

Risk ratings are based on the credit risk (not market risk) of the pool of securitized loans or receivables as well as the priority of how they absorb losses.

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Credit Card Securitization: Example

Which of the following statements about credit card securitization is correct?

A. Additional fee income is generated for the issuer.

B. The credit card receivables are kept on the issuer's balance sheet.
Credit card receivables are removed from the issuer's balance sheet, which provides both capital efficiency and reduces the cost of funding.

C. The cost of default risk from credit card debt to the issuer increases.
The cost of default risk from credit card debt is reduced.

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Collateralized Loan Obligations: Example

Which of the following statements about collateralized loan obligations (CLOs) is incorrect?

A. Recourse is limited to the collateral pool, with minimal recourse to the original issuers.

B. Investors in senior or mezzanine bond classes typically earn a lower yield than comparable corporate bonds.

C. After the ramp-up period, the collateral manager may replace loans in the portfolio as long as the new asset meets the portfolio selection criteria.

Investors in senior or mezzanine bond classes earn a potentially higher yield than comparable corporate bonds offer.

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Credit Enhancement: Example

The external credit enhancement that has the *least* amount of third-party risk is a:

A. surety bond.

B. letter of credit.

C. cash collateral account.

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