

A horizontal banner with a light blue background. On the left, there is a vertical teal stripe. The main area is light blue and contains the text "Fixed Income" in white. On the right side, there is a large, stylized white arrow pointing to the right.

Fixed Income

A horizontal banner with a light blue background. On the left, there is a vertical teal stripe. The main area is light blue and contains the text "Fixed-Income Securitization" in white. On the right side, there is a large, stylized white arrow pointing to the right.

Fixed-Income Securitization



Exam Focus

- What is securitization?
- Parties involved
- Benefits
- Risks

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What Is Securitization?

1. A pool of debt-based assets (collateral) is created by a bank making loans or a corporation offering customers credit.
 2. A pool of assets is sold to a special purpose entity (SPE).
 3. An SPE issues fixed-income securities (ABSs), serviced by the cash flows from the collateral (e.g., borrowers repaying their loans).
- Connects investors (purchases of ABSs) with those who need capital (original borrowers)

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Securitization: Example

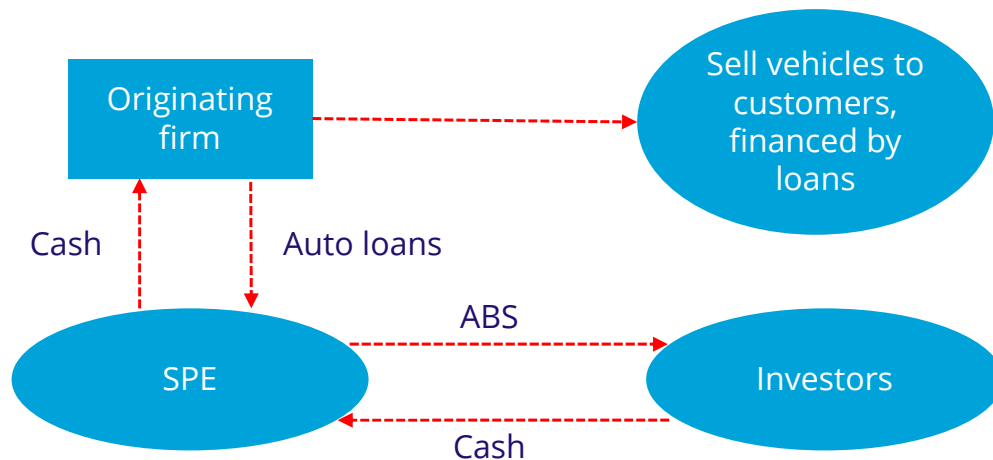
- In 2019, the performing-rights company, SESAC, issued securitized bonds backed by its music royalties and licensing agreements with more than 30,000 artists, including Adele, Bob Dylan, Kesha, Gabriel Mann, and R.E.M.
- The largest piece of the securitization was a fixed-rate note, worth \$530 million with a weighted average life of 6.7 years. The note offered a yield of 5.25%.
- The smaller portion of the deal was a floating-rate note, worth \$30 million with a weighted average life of 4.9 years, which was not publicly offered.
- This type of offering is known as a “whole-business securitization.” This type of bond usually is backed by such assets as restaurant franchise agreements or other unusual assets and typically pays higher rates than more traditional ABS tied to consumer debt.

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Parties Involved: Example



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SPE: Example

- Ahbaling Industries (Ahbaling) has SGD500 million of corporate bonds outstanding with a credit rating below investment grade.
- Ahbaling has SGD400 million of receivables. Receivables represent payments Ahbaling expects to receive for machine tools it has sold to various customers in Europe.
- Ahbaling's finance subsidiary sells the receivables to Ahbaling Trust, an SPE. Ahbaling Trust then issues ABS, backed by the pool of receivables, with the following structure:

Bond Class	Par Value (SGD Millions)
A (senior)	280
B (subordinated)	60
C (subordinated)	60
Total	400

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SPE: Example

If Ahbaling Industries issues SGD400 million in corporate bonds one year from now:

- A. the new bonds will be senior to the ABS.
- B. the ABS will be senior to the new bonds.
- C. seniority will not apply between the new bonds and the ABS.

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SPE: Example

Identify the *most important* reason why the ABS issued by Ahbaling Trust offers a lower interest rate than the existing Ahbaling Industries corporate bonds outstanding.

- A. Ahbaling Industries' existing bonds are rated below investment grade.
- B. Ahbaling Trust would not be affected if Ahbaling Industries files for bankruptcy.
- C. The ABS issued by Ahbaling Trust are secured by collateral, the receivables purchased from Ahbaling Industries.

-1

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Benefits to Originating Bank/Corporation

- Increased business activity
- Improved profitability
- Lower capital reserves (for banks)
- Improved liquidity

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Benefits to Investors

- Tailored risk and return
- Access
- Liquidity

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Benefits of Securitized Debt: **Example**

- Pawas Singhvi, an investment manager for a defined benefit pension fund at a large manufacturer, is discussing investment options and expectations with a new associate, Kevin Epstein.
- Epstein asks why Singhvi holds a significant portion of fund assets in securitized debt. Singhvi explains that a number of parameters and expectations influence the investments selected for the pension fund, starting with asset and income diversification.
- The fund seeks safe, diversified assets and income streams, which offer low risk. Anticipated pension payments or outflows from the fund drive the need for liquid and stable investments, which mature or can be sold easily to match the timing of required cash outflows. Any fund investments must be highly rated.

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Benefits of Securitized Debt: **Example**

- Because pension payouts take place over many years into the future, pension assets must be invested long-term, too.
- And the fund's assets must grow over time in order to produce promised pension payments at the levels required in the future.
- While public, government-issued debt is highly rated and typically safe, it alone may not produce sufficient returns to meet future obligations.
- By contrast, holding investment-grade, publicly traded, securitized debt, which can be traded, allows us to garner higher returns and to respond quickly to changes in market sentiment, risk sensitivity, or funding needs at low transaction costs.

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Benefits to Economies and Financial Markets

- Decreased liquidity risk
- Improved market efficiency
- Lower financing costs for originators
- Lower leverage for originators

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Risks to Investors

- Cash flows from collateral to ABS investors are uncertain and can vary in timing and size.
- The credit risk of collateral is passed to investors.

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Securitization Benefits: **Example**

Matching asset maturities to anticipated liability payout dates and increasing diversity in an asset pool while maintaining the option to adjust holdings quickly and cost-effectively is *most likely* a benefit to:

- A. issuers.
- B. investors.
- C. economies and financial markets.

-1

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Solutions

SPE: Example

If Ahbaling Industries issues SGD400 million in corporate bonds one year from now:

- A. the new bonds will be senior to the ABS.
- B. the ABS will be senior to the new bonds.
- ☒ C. seniority will not apply between the new bonds and the ABS.

Because the new bonds are issued by Ahbaling Industries and the ABS are issued by Ahbaling Trust (two distinct entities), seniority will not apply.

-1

SPE: Example

Identify the *most important* reason why the ABS issued by Ahbaling Trust offers a lower interest rate than the existing Ahbaling Industries corporate bonds outstanding.

- A. Ahbaling Industries' existing bonds are rated below investment grade.
The credit rating on Ahbaling Industries' existing bonds does not dictate the interest rate on the ABS issued by Ahbaling Trust.
- B. Ahbaling Trust would not be affected if Ahbaling Industries files for bankruptcy.
Even though Ahbaling Trust, as a separate legal entity, would not be affected if Ahbaling Industries files for bankruptcy, this is not the most important reason that the ABS requires a lower interest rate.
- ☒ C. The ABS issued by Ahbaling Trust are secured by collateral, the receivables purchased from Ahbaling Industries.

A secured bond is secured by collateral and is considered less risky than an unsecured bond without collateral backing—and accordingly, has a lower credit spread than an unsecured bond.

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Securitization Benefits: Example

Matching asset maturities to anticipated liability payout dates and increasing diversity in an asset pool while maintaining the option to adjust holdings quickly and cost-effectively is *most likely* a benefit to:

- A. issuers.
- ☒ B. investors.
- C. economies and financial markets.

Matching asset maturities to anticipated liability payout dates and increasing diversity in an asset pool while maintaining the option to adjust holdings quickly and cost effectively is most likely a benefit to investors.

For example, a pension fund with a long-term horizon can use securitized debt gains to achieve higher returns, match asset maturities to anticipated liability payout dates, and increase diversity in its asset pool while maintaining the option to adjust holdings quickly and cost effectively.

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