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TO TELL FUTURE

The future of securitization - what, if any?

Funding has become an increasingly worrying topic for banks as they themselves struggle to obtain senior secured funding at reasonable prices since the credit market dislocation. With credit rating cuts causing spikes in credit default swaps and, ultimately, the increased cost of secured and unsecured borrowing, finding new sources of funding - or reviving old ones - has become a priority.

With the start of the global credit crisis in mid-2007 that was followed by the banking sector liquidity crisis, market appetite for structured products, including Asset-Backed Securities (ABS), decreased until it almost disappeared in certain parts of the world. In the Middle East and other developing markets, securitization was one of the victims of the financial crisis. Securitization of assets was still immature in the Middle East region when the whole financial recession started, which led to this type of structured product to source funds at lower costs being the first of financial market products to fade away.

But is this demise unfair? Investors sometimes wonder what truly started the credit crisis: was it the inherent complexity of securitization, which limited investors' ability to monitor risk, or was it the many other vital factors such as the underestimation of risk undertaken by the investors, over-reliance on rating agencies, lack of data transparency, undue trust in mathematical models shadowing aggressive decisions taken by the some of the leading financial institutions?

Given the benefits of the securitization, which started a few decades ago, one can only conclude that the securitization market is a good mechanism to source low-priced funds and manage liquidity should the market participants overcome its associated challenges.

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Why securitize?

Among all the available sources of funds to financial institutions, such as customer deposits, money markets, secured/unsecured capital markets bonds and raising capital, low-priced secured borrowing through ABS and covered bonds is always deemed favorable for both, the borrower - in terms of minimizing cost of funding and reducing liquidity risk - and the investor - in terms of achieving reasonably good returns for secured investments with senior rating.

One case in point: during the global financial crisis in 2009 - 2010, when investors' appetite for securitized products had deteriorated, the governments of larger economies bailed out some of the larger financial institutions through the acceptance to buy securitized issuance, where the underlying packaged assets met a defined criteria stipulated by the central banks.

Benefits of securitization for the Middle East region

Lower cost of funding with lower funding risk

As a result of the recent liquidity pressures in the euro-zone and the Arab spring leading to political uncertainties, credit growth is expected to be limited in the Middle East in 2012, which will affect certain industry sectors such as real estate. Financial institutions will therefore continue to focus on reducing their funding cost, improving liquidity and increasing asset quality very cautiously in order to maintain profitability at high and consistent levels.

Although the banking sector in the Middle East, and particularly in the United Arab Emirates (UAE), is very well capitalized and most banks' capital adequacy ratios are well above the level required by Basel II, it has been noted that these banks' long-term loans and advances are predominantly funded by short-term borrowings such as customer deposits and money market products, as these are better priced compared to the capital markets. However, this strategy is expected to ultimately add more pressure on the banks' liquidity management in the long run.

According to a Standard & Poor's (S&P) report published in November 2011, "the large amount of regional debt maturing between 2012 and 2014 will add to the refinancing risk facing issuers in the Gulf Cooperation Council (GCC) countries. Industry experts estimate bonds and 'sukuk' of about USD 25 billion will mature in 2012, rising to about USD 35 billion in 2014."

Taking all that into consideration, banks may need to recapitalize their balance sheet, changing their funding strategy of reliance on short-term borrowing to fund longer-term assets, in order to reduce their funding mismatch. One of the possible solutions to secure funding at a low cost, manage liquidity risk and ultimately improve profitability, could be long-term securitized issuance, which is a good alternative until unsecured borrowing from capital markets comes back at an attractive and reasonable cost.

Stimulating the economy and real estate market

To stimulate the economy, there has to be an increase in loans originated by financial institutions in the market, whence funds from such loans will be deployed in the local economy such as the real estate market and other weakening industry sectors.

As regards real estate lending products, banks are still charging considerably high interest rates and demanding higher deposits in order to reduce their funding risk (i.e. in the UAE, banks are requesting loan to value ratios of 80%). This has resulted in a very slow rate of loan originations, in particular mortgages origination, over the past couple of years, leading ultimately to lower demand in the real estate market and an ongoing decrease in property prices.

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With banks shifting back to capital markets and secured borrowing, such as ABS and covered bonds, they will deleverage their balance sheets, improve their maturity profile, reduce their credit exposures and free up some cash for additional lending, which will eventually improve the economy, including the real estate market.

No such thing as a free lunch

The question that begs itself is: if securitization comes with all the benefits listed above, then why aren't we seeing any securitized issuances taking place in our market?

Global development

Many investors still consider securitization as a tainted product. Only those global originators that are able to sell a strong core competency and brand have consistently been able to successfully place new issuances.

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Critics have suggested that the complexity inherent in securitization can limit investors' ability to monitor risk and that competitive securitization markets with multiple securitizers may be particularly prone to sharp declines in underwriting standards.

In recent global securitization conferences, market participants have also been discussing the need for simple transaction structures and granular portfolios to revive investor interest in securitizations. Despite a strong desire for more detailed transaction information by market participants, there is an opposing view that too much information could be overwhelming, with small investors potentially struggling to accept it.

Since the start of 2011, the market has diverted to the issuance of covered bonds as opposed to Assets Backed Securities. With covered bonds data transparency has become less of a worry to investors, as covered bonds are considered a liability to the issuer. The investor has recourse to both, the pool of packaged loans and the issuer to recover his investment, resulting in credit risk being much less and in this type of structured products becoming more popular.

Market maturity and operational readiness

The revival of securitization in the Middle East poses even greater challenges than in more developed and mature markets. The concept of securitization in the UAE market was still new at the onset of the global financial crisis. As a result, investors' and issuers' awareness of the associated risks was still not up to par, leaving all local market participants very reluctant to enter into this vague type of structured product.

Furthermore, securitization structures require ongoing operational support by various service providers normally independent of the originators, such as trustees, fund managers and servicers, in order to manage the vehicle's cash waterfall calculation, cash management, custody of collateral held and managing the investor reporting process. With the securitization process still immature in our market and the limited exposure of our local service providers, the cost associated with these services has become too expensive, as most entities seeking to securitize their assets would need to source these services from expensive international providers.

Data transparency

The absence of investors' required market data, such as loans delinquency level, details of the asset vintage, weighted average life of assets and collaterals values, renders the quality of data below the required level of information available in mature markets. That results in higher challenges for the rating agencies to assess the associated risk appropriately and to the central bank to approve such issuances. As a result, investors will eventually lose confidence in the market and will have no appetite to invest in Asset-Backed Securities.

Real estate market

Considering the high level of delinquent mortgages – resulting from the significant decline in demand over the past three years in the UAE real estate market and the current political unrest in the region – it is unclear whether further deterioration in property prices is yet to come. This of course leaves the current portfolio of mortgages carried by financial institutions in the region ineligible for packaging in a solid mortgage-backed securities issuance at a price that would be agreeable to investors.

The future, or not?

Despite the positive attributes of securitization, these might still be outweighed by several challenges in the Middle East.

While some of the challenges can still be dealt with – securitized/covered bond issuers can still opt for safer asset types with more transparent market information such as auto-loans, credit cards, energy or telecom accounts receivables – there are persistent external challenges to deal with such as market immaturity and readiness, an unstable political situation and limited growth in the economy. All that will result in prolonging the recovery of the securitization market in the Middle East.

Prior to working on regaining investor interest in securitized assets or covered bonds, external challenges should be resolved and more transparent data should be made available by the originators. Without resolving these challenges, the concept of securitization will continue to fade away.

by **Musa Ramahi**, Audit principal, Deloitte in the Middle East

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What is securitization?

The securitization of assets is a feasible way to fund medium- to long-term assets through the issuance of secured medium to long term bonds (Asset Backed Securities or ABS) at a lower cost and still have longer maturity periods than other common funding sources such as money market borrowings and short-term deposits.

This mechanism is achieved through the pooling of diverse types of contractual debt with similar characteristics such as residential mortgages, commercial mortgages, auto loans or credit card debt obligations and funding it through the issuance of consolidated tranches of debt as bonds, pass-through securities, or collateralized mortgage obligations (CMOs), to various investors attracted by significantly reduced credit risk associated with these assets.