

Bond Basics

January 2007

Bond Basics: Asset-Backed Securities

Asset-backed securities (ABS) can offer investors high quality and yields that compare favourably to government and covered bonds. The variety within the ABS sector itself can also help investors diversify their high-quality holdings without adding significant risk.

This article will explain the basics of asset-backed securities and why they are popular with both issuers and investors.

What Are Asset-Backed Securities?

Introduced in the mid-1980s in the U.S., asset-backed securities are bonds backed by pools of loans or other receivables, such as leases. In Europe, ABS can be created from many types of assets, from residential and commercial mortgages to auto loans and credit card receivables.

Creating bonds from a pool of loans or receivables involves a process called **securitisation**. In this process, the originator of the loans (or receivables)—which is typically a bank but can be a finance company, a government, or other lender—selects a group of loans from its portfolio. The originator then sells this pool of loans to a special purpose vehicle (SPV) set up solely for the ABS transaction. In turn, the SPV usually issues the asset-backed securities to investors.

The goal of the securitisation process is to isolate the loans, or assets, and ensure that payments on the ABS come exclusively from the pool of assets rather than from the lender that originated the assets. To accomplish this, the sale of the assets to the SPV must be a “**true sale**” in legal terms. When a true sale occurs, the lender can move the assets off balance sheet, and investors in the ABS have the right to the cash flows on the pool of assets even if the lender becomes bankrupt. The true sale of assets distinguishes ABS from other types of bonds, which are typically the obligation of the lender/originator.

The payments on the underlying loans or receivables may be passed directly onto investors as they flow into the SPV, or they may collect in the SPV for a specified period of time to pay principal and interest on a schedule designed to appeal to investors. Some mortgage- and auto loan-backed securities pass monthly principal and interest payments directly to ABS investors as monthly bond payments. The cash flows from many other asset types, including credit card receivables, usually accumulate in the trust and are reinvested in new assets during the life of the transaction. Interest is paid quarterly or every six-months and principal is returned at maturity—a “bullet” payment structure that resembles the payout on many corporate bonds.

The payment structure on an ABS depends on investor demand and to some extent on the nature of the underlying receivables. In general, securities backed by auto, credit card and other consumer assets have short-to intermediate-term maturities—from three to seven years—because they are backed by relatively short-term assets and fill

Bond Basics

January 2007

investors' need for high quality investments in that maturity range. Securities backed by mortgages, however, tend to have longer maturities because the loans have longer terms and the securities fill a different niche in an investment portfolio. Securities backed by very short-term assets, such as credit card receivables, can be designed to meet investor demand for any maturity because new assets are continuously added to the pool as older receivables are paid off by borrowers.

In Europe, residential mortgage-backed securities are generally included in the broad category of asset-backed securities, or "securitisation." This is an important distinction from the U.S. market, where two distinct sectors have evolved.

There are two main reasons why the markets differ in this way. First, a typical U.S. residential mortgage-backed security is a unique investment that carries a high degree of **prepayment, or interest-rate, risk**. In the U.S., most mortgages are fixed rate and most lenders do not charge fees to borrowers for prepaying mortgages. When interest rates change, prepayments on U.S. mortgages can rise or fall quickly, and the securities backed by those mortgages may therefore pay investors earlier or later than expected. By contrast, in Europe, many mortgages are floating-rate, and many lenders charge fees for prepayments. Because borrowers have little incentive to prepay their mortgages, mortgage-backed securities in Europe tend to perform much like other types of ABS in terms of prepayments.

Second, most U.S. mortgages carry guarantees, either explicit or implicit, from the U.S. government. As a result, credit in general is not a major risk in the U.S. residential mortgage-backed securities market. Europe does not have a similar guarantee system and therefore, European mortgage-backed securities carry credit risk much like other types of ABS.

Credit Enhancement Differentiates ABS

Unlike most other bonds, the credit quality of an ABS transaction depends not on the originator but rather on the performance of the underlying assets—that is, whether or not the loans/receivables will be paid. To protect ABS investors from the possibility that some borrowers could miss payments or even default on their loans, ABS include credit support, or credit enhancement.

Several forms of credit enhancement have evolved, and often a single ABS transaction will depend on a combination of credit enhancements. The most common credit supports include:

- **Subordination.** This enhancement involves slicing the ABS into two or more classes of securities, known as tranches. "Senior" tranches have priority over other "subordinated" classes in terms of payment. So losses on the underlying loans would first affect investors in the subordinate securities. Reflecting their relative credit risk, senior securities usually receive the highest credit ratings and offer the lowest yields to investors, while subordinate securities carry lower ratings and higher yields.

Bond Basics

January 2007

- **Excess spread.** Excess spread is the difference between the average coupon (or interest rate) on the underlying loans and the coupon on the ABS. For example, if a pool of auto loans has an average interest rate of 7% and the ABS created from those loans pay a coupon of 6%, the excess servicing in the ABS transaction would be 1%. This 1% cushion can be used to cover initial losses or payment delays on the auto loans so that investors are not affected.
- **Overcollateralisation.** The value of the pool of assets backing an ABS often exceeds the value of the securities. The excess serves as a protection against losses.
- **Cash collateral account or reserve account:** The originator can set aside cash, perhaps 5%-10% of the total ABS transaction, in a separate account to cover potential losses on the loans in an ABS. A cash account provided by a third party for a fee is a “cash collateral account,” while an account from the originator is called a “reserve account.”
- **Financial guarantee.** Also known as a “wrap,” a financial guarantee is bond insurance purchased by the originator to protect investors against all losses and therefore make the bonds more attractive to investors. Bond insurance companies, such as Ambac, Financial Guaranty Insurance Company and MBIA provide this service.

Why Issue ABS?

Setting up a securitisation program, including systems to track the performance of the assets, can be expensive. However, for issuers, raising funds through ABS can offer several benefits that more traditional financing, like corporate debt, cannot:

- **Lower cost of funds.** Because the assets are separated from the originator/lender, an ABS can obtain a significantly higher credit rating than that of the originator. This results in lower interest payments to investors and reduces the overall cost of funds for the originator.
- **Off-balance-sheet treatment.** Selling the receivables to a separate company in a true sale moves these assets off the originator's balance sheet and thus potentially allows the originator to make more loans or generate more receivables.
- **Reduced bank capital requirements.** Banking regulatory agencies require that banks hold capital in reserve against their loans to protect them from potential losses; banks can hold much less capital against securitised loans because the credit risk has been largely transferred to the ABS transactions.

Why Invest in ABS?

Because of the complexity of ABS, investors often hire specialists to analyze the securities. What makes ABS worth the effort for investors? The attractions of investing in ABS include:

- **High credit quality.** In the Lehman Brothers European ABS Index, 91% of ABS receive the highest credit rating of triple-A. Because so few companies and banks maintain a triple- or even double-A rating today, ABS can fill investors' need for high quality investments.

Bond Basics

January 2007

- **Diversification.** By buying ABS, investors can diversify away from other highly rated bonds, such as sovereigns and agency bonds. Also, the universe of ABS is diverse in itself because the bonds are backed by many different assets and have unique payment and credit characteristics.
- **Yield.** ABS can offer yields higher than sovereign bonds and a similar yield to corporate bonds with comparable ratings and maturities.
- **Reduced event risk.** By separating the assets from the originator, ABS can insulate investors from events that affect the originator, such as a takeover or a credit-rating downgrade. Properly structured ABS may even continue performing if the originator goes into bankruptcy.

Risks of Investing in ABS

There are risks associated with investing in ABS, despite their high credit quality.

Like corporate bonds, ABS carry **credit or default risk**. If many borrowers on the underlying loans default, losses could exceed the credit enhancement level and result in losses to investors in an ABS transaction. Some ABS are also subject to **interest-rate risk, or prepayment risk**. A change in interest rates can affect the pace of payments on some loans, which in turn, can affect total return on the securities. Although many lenders in Europe charge fees to mortgage borrowers who prepay their loans early, as noted above, prepayments can still occur on mortgages and other types of assets, such as auto loans.

Finally, ABS have **structure risk** due to a unique characteristic known as **early amortization, or early payout, risk**. To protect investors from losses, triggers are built into the structure of most asset-backed securities that can cause early payout. These triggers are unique to each transaction and can include: a big rise in defaults on the underlying loans, a sharp drop in the credit enhancement level, or even the bankruptcy of the originator. Once early amortization begins, all incoming loan payments are used to pay investors back as quickly as possible.

Conclusion

For investors, asset-backed securities can offer high credit quality, higher yields than government bonds, and diversification. Through the process of securitisation, banks, governments and other lenders can create bonds from the cash flows on their loans. The key to securitisation is the legal true sale from the lender to a special purpose vehicle; when a true sale occurs, the asset-backed securities become the obligation of the special purpose vehicle rather than the lender. As a result, the lender can move the loans off the balance sheet, and ABS investors are protected if the issuer goes into bankruptcy because they have the right to the cash flows on the loans.

Bond Basics

January 2007

London

PIMCO Europe Ltd
Nations House
103 Wigmore Street
London W1U 1QS
England
44-20-78721300

Munich

PIMCO Europe Ltd Munich Branch
Nymphenburger Straße 112-116
80636 Munich
Germany
49-89-1221-90

Rotterdam

PIMCO Europe Ltd2
Regus Brainpark II
Lichtenauerlaan 102-120
3062 ME Rotterdam
The Netherlands
TEL 31-10-204-5722

PIMCO Europe Ltd., PIMCO Europe Ltd. Munich Branch, and PIMCO Europe Ltd. Rotterdam Branch are authorised and regulated by the Financial Services Authority in the UK. PIMCO Europe Ltd. Munich Branch is additionally regulated by the BaFin in Germany in accordance with Section 53b of the German Banking Act and PIMCO Europe Ltd. Rotterdam Branch is additionally regulated by the AFM in the Netherlands. The services and products provided by PIMCO Europe Ltd. are available only to investors who come within the category of market counterparty or intermediate customer as defined in the Financial Services Authority's Handbook. They are not available to individual investors, who should not rely on this communication.

Diversification does not ensure against losses.

Past performance is no guarantee of future results. This presentation contains the current opinions of the manager and such opinions are subject to change without notice. This presentation has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission of PIMCO 2007