The Long Road to Middle-Market Securitization

by Francis Garritt, Eric Taub, and D.K. Malhotra

Fewer but more risk-averse lenders, plus loan losses and lack of sufficient capital market fees to go around, have led to the middle-market collateralized loan obligation (CLO), the next step in the ongoing growth of loan securitizations. This article discusses the growth of middle-market securitization, the issues involved, and the long road ahead.

In recent years, financial innovation has been evolving at a breath-taking pace. Practically each day, new products or services appear on the horizon. One such financial innovation is *middle-market securitization*—the outgrowth of securitized lending, first introduced in 1968, and a large middle market of loans. Middle-market *collateralized loan obligations* (CLOs) are the next step in the ongoing growth of loan securitizations.[1]

Securitization is a form of financing in which a lender packages a group of assets—such as car loans, mortgages, or credit card receivables—and issues securities against the future cash flows. The securities are traded as fixed-income securities, similar to bonds. By securitizing assets, lenders can recycle the future cash flows into another round of car loans, mortgages, and credit card charges. This particular financial innovation has helped keep the American consumer buoyed in credit. And it explains why, despite a recession and an imploding stock market, people are still buying cars and houses at a frenetic pace.

Securitized lending had its start with the Government National Mortgage Association, or "Ginnie Mae," created in 1968 to package home mortgages that met strict lending guidelines. In the past decade, securitizing of mortgages has taken off, having climbed to a staggering total of $6 trillion. By comparison, all household debt in the U.S. currently totals $7.7 trillion.

There are two major benefits to a lender securitizing its book of loans. The first benefit is that the lender receives the present value of a future stream of cash flows

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from assets (that is, consumer loans), and virtually all the liabilities (the securities issued to investors) leave its balance sheet. Investors are thrilled with the arrangement because they can look to a predictable stream of consumer loan repayments to back up the debt securities they have purchased.

The second benefit to the lender is that if it gets into trouble, it gets first dibs on that cash stream. In addition, for lenders, keeping those assets and liabilities buried in footnotes rather than on the balance sheet is crucial. If they were to consolidate them, some lenders would look dangerously leveraged.

Securitization is big business for financial institutions. Citigroup has $204 billion of asset-backed debt outstanding, and JPMorgan Chase has $75 billion. The largest credit card issuer, MBNA, has $73 billion compared to on-balance-sheet assets of $45.4 billion and a comparative sliver of shareholders' equity, $7.8 billion. Ford Motor Credit was able to save several hundred million dollars over the past 18 months using off-balance-sheet financing. GMAC is another big player. In addition, securitization has helped the major automakers offer 0% financing, which may not have been possible otherwise. It also represents an arbitrage opportunity for asset managers in that they can buy assets at a discount in order to resell them in the market through securitization.

The middle market consists of companies that are too big for one financial institution to handle, but not big enough to obtain financing in the bond or equity markets. Basically, the middle market encompasses companies that have annual sales of between $50 million and $500 million. Such companies tend to have less access to capital and more dependence on banks for financing. A middle-market loan is often used for an LBO, an acquisition, or an expansion.

Compared with larger companies, middle-market companies typically have more conservative capitalization levels and smaller differences between margined assets and debt levels. The tenor on middle-market loans is also shorter than that of loans to larger entities: generally three to five years. Additionally, middle-market companies are forced to secure their loans with all of their assets.

The lack of alternative financing for the middle market is a double-edged sword for banks. Having a captive aud ience, banks can receive higher fees, more conservative structures, and better returns on assets. Banks depend on the middle-market companies to pay them back with cash flow. However, in times of trouble, middle-market companies cannot easily issue equity or subordinated debt to refinance their bank debt. There is no secondary trading market for middle-market loans as there is for large loans. Therefore, banks are wary of the middle market, as it can become a "roach motel": Money goes in, but it cannot come out.

Why Middle-Market CLOs?

Historically, banks and specialty finance companies have been the lenders to leveraged middle-market companies. For years, banks looked at the middle-market-sponsored loan as an opportunity to adjoin lending and capital market fees to create a compelling overall return. Banks would invest in the partnership of leveraged buyout sponsors, who, in turn, would use the banks to finance purchases of middle-market companies. The banks would benefit from the equity return on their limited partnership investment while garnering underwriting fees and interest paid on the loans to finance the buyout.

Two problems arose. First, the consolidation of both bank and specialty finance companies throughout the 1990s led to fewer but more risk-averse lenders, reducing the pool of capital dedicated to the middle-market loan. Second, loan losses and lack of enough capital market fees to go

Table 1

A Summary of the Middle-Market Structures Launched by Various Issuers

Vehicle	Manager/Sponsor
ACAS Business Loan Trust 2000-1	American Capital Strategies Ltd
CapitalSource Commercial Loan Trust 2001-1	CapitalSource Finance LLC
MCG Commercial Loan Trust 2001-1	MCG Capital Corp
CapitalSource Commercial Loan Trust 2002-1	CapitalSource Finance LLC
ACAS Business Loan Trust 2002-1	American Capital Strategies Ltd
Fleet Commercial Loan Master 2002-1	Fleet National Bank
CapitalSource Commercial Loan Trust 2002-2	CapitalSource Finance LLC
ACAS Business Loan Trust 2002-2	American Capital Strategies Ltd

around led to portfolio returns that were below expected levels.

The solution to these issues has been the middle-market collateralized loan obligation, or CLO. So far, eight middle-market structures have been launched. The specialty lenders seem to have especially liked the idea of these structures; indeed, ACAS and CapitalSource have each launched three of them. Moreover, specialty lenders have used these structures to lower their cost of capital and improve their ability to finance smaller deals. An added benefit is asset/liability matching. Table 1 summarizes the middle-market structures launched to date.

These issuers are not interested in risk management or balance sheet relief for the vehicles. However, they have opened the door in relation to ratings methodology, structure, and investor interest. Fleet National, a large bank with a larger concentration in middle-market loans, has also joined the fray. Fleet is clearly using CLOs to move risk off the balance sheet. The Fleet deal is a classic attempt to lower the unexpected loss associated with the investment.

As discussed, the first large CLOs were created to take advantage of too much capital allocated to investment-grade loans. In some ways, middle-market securitizations can take advantage of the excessive costs to a banks' stock price based on its nonperforming assets. Basically, a CLO prices itself based on the cash flows from the interest and principal payments of the underlying loans. If a loan defaults, assumptions are made for recovery timing and amount. These assumptions are particularly onerous for lower-rated credits. According to Moody's, from 1982-2001, senior secured bank loans recovered 71.28% of par after default.[2] The waterfall models used by the ratings agencies have recovery rates of 30-50% in event of default. Therefore, the equity benefits on average from better recoveries. Meanwhile, banks have to show the nonperforming loans on their balance sheets. This affects their stock prices, as nonperforming loans are a measure of future losses. There is an inherent benefit to these structures as they take bad loans off balance sheet.

Structurally speaking, these deals tend to have all the bells and whistles of a typical CLO: overcollateralization tests, interest-coverage tests, minimum diversification, and concentration limitations. The problem for middle-market securitization is having enough loans to meet the criterion, which tends to mean higher industry concentrations and a smaller number of loans than for other CLOs. To mitigate these added risks, middle-market deals have added factors that make them more onerous to the manager. They include larger equity positions (sometimes up to 25% of the vehicle), cash collateral accounts, credit enhancements, and restrictions on substitutions. The concept is essentially the same as that for credit card securitizations. In credit card securitizations, the lack of diversity is mitigated through other factors, such as wrapping and using a large number of loans.

Benefits of Middle-Market Securitization

Financial institutions lending to middle-market companies today have a variety of reasons for securitizing these assets. The structured financing techniques are used by financial institutions looking for alternate sources of funding or for cash to expand their business by buying back capital. What accountants, regulators, and lawmakers decide in the days ahead about the permissible uses of SPEs may have far-reaching consequences for securitizations.

Securitized financing through

SPEs has several attributes that may prove beneficial for financial institutions lending to middle-market companies:

- Off-balance-sheet funding.
- Improved rating of the new securities.
- Lower all-in cost of funding.
- Diversified funding sources.
- Lower capital requirements (both regulatory and economic).

Structured financings such as securitizations often involve higher transaction costs due to their overall complexity, and this will be especially true with middle-market securitizations. In addition, the heightened scrutiny from investors, lawmakers, and regulators since Enron must also be considered. However, despite Enron's questionable use of SPEs, the $5 trillion securitization market is one that works very well.

When these loans are aggregated into a CLO structure, the market determines the capital allocation based on the expected loss. Therefore, a bank can take advantage of this arbitrage in cases where the higher-rated/lower-risk credit is being charged too much capital for its expected loss. An investment-grade CLO rectifies the error of initial Basel accords as it assigns the expected loss its mathematically low probability as the small equity portion.

The world of banking is rapidly moving toward Basel II, which is the next round of bank regulatory rules. These rules are looking to rectify the error of giving equal rating to all credits regardless of risk. The focus is on charging more capital for lower-rated assets, forcing banks to look at economic capital, which is the capital necessary to address the unexpected loss.

> **BANKS PEDDLING SECURITIZATION DEALS CONTRIBUTE A GROWING SLICE OF REVENUE FOR THE RATINGS AGENCIES. AT MOODY'S, STRUCTURED FINANCE NOW ACCOUNTS FOR 43% OF TOTAL**

Expected loss is set in the price—and when something is sold, the yield should reflect that probability. Unexpected loss is the downside variation from the loss. Just because the average annual default rate and recovery rates for a Ba3 credit were 2.81% and 70% over the last 20 years does not mean that they will be 2.81% and 70% next year. The volatility of default rates and recovery rates needs to be addressed through the allocation of capital, which is the economic capital.

When a bank creates a CLO, it off-loads that unexpected loss to the liability holders. The equity holds the expected loss and manages toward a better-than-average result, providing the incentive for lenders to take leveraged loans off their books. It is the risk of unexpected loss that ruins smooth earnings and creates bumps in the road. In the case of middle-market loans, there exists a higher volatility in default rates and recovery rates. Banks will therefore be drawn to these structures as they remove the high economic capital associated with these loans.

Issues Facing Middle-Market Securitizations

Lack of transparency. The foremost issue facing middle-market securitization is the need for transparency in the rating of debt issues. The ratings industry is changing. The days when agencies earned most of their fees from individual borrowers are fast disappearing. Banks peddling securitization deals contribute a growing slice of revenue for the ratings agencies. At Moody's, structured finance now accounts for 43% of total ratings revenue. Moreover, structured-finance revenue in the second quarter of 2002 grew 43% from a year earlier, compared with 15% growth in other ratings revenue.

Agencies are scrambling to keep up with the pace of innovation. What's more, the handfuls of big banks that sponsor the bulk of the deals are innovative and aggressive. They shop the SPEs to the agencies for the most favorable rating. Agencies certainly have a checkered past in regard to the rating of complex structures. In the first half of this year, Standard & Poor's downgraded 60 collateralized debt obligations and upgraded only one. Meanwhile, the downgrade-to-upgrade ratio was 7:1 for asset-backed securities. The agency's global credit ratio, which captures all rated instruments, showed a downgrade-to-upgrade ratio of only 4:1.

The ratings agencies have started to wake up to the problem. S&P wants to increase the

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amount of its revenue coming from other sources. Nevertheless, it will be a long road. Moody's, for instance, still gets 85% of its revenue from issuers.

Lack of public debt rating. The ratings agencies do not tend to rate middle-market companies. This is a major hurdle to creating a portfolio of these assets for a CLO structure. Since the underlying assets need to be assigned a default probability, it is necessary for the CLO to have built in the cost of a "shadow" rating for each asset.

The ratings agencies are trying to facilitate the ability to rate middle-market companies, which in turn will help create middle-market structures and expand the market. One way in which ratings agencies are offering a flexible solution to this problem is by mapping to banks' internal credit processes. If a bank can show a history of default and recovery along with a codified credit process, Moody's will allow the bank to map to certain ratings levels.

The idea in mapping is to credit a bank for its own internal structure and facilitate the creation of an external ratings methodology within the confines of the bank's own system. The problems within this concept have been manifested by the real world. Banks have been in a consolidating and changing environment, which often precludes a sufficient history of default and recovery. Further, banks have been changing their risk models over time, creating a fluid credit process that is hard to compare to past systems.

At the end of the day, there are measures to define risk and loss for middle-market credits. The problem lies in the albatross of size. Middle-market credits are considered a higher risk by ratings agencies because, on a single-credit basis, they are more susceptible to deteriorating economic conditions. However, in a diversified industry and geographic pool, these risks should be mitigated. Accordingly, the idea of a portfolio of these assets receiving a higher rating is not only logical, but also practical on a funding basis.

In short, the ratings agencies use a stressed default and recovery probability based on the underlying assets in the structure. This approach allows them to determine the likelihood of a scenario in which each tranche of debt will experience a loss of principal. Credit is given for diversification across industries—which, in theory, will reduce the probability of correlated defaults. Issuer, industry, rating, and geography define baskets. The tranches are then rated and sold to third-party investors at market interest rates.

The key intention of the structure is to maximize the highest-rated portion of the vehicle in order to lower the cost of funding. The ratings agency must review the structure on a regular basis to determine if the credit has experienced any deterioration.

Options for Smaller Banks

Despite the trend that continues to create even larger banking organizations, the vast majority of banks remain community banks. Community banks are typically smaller banks that have fewer than $500 million in assets and are more common in rural areas.

The future of securitizations will at least go one of the two following ways. As the market for middle-market securitizations increases in size, and ratings and pricing therefore become more transparent, large or regional investment banks will have the opportunities to purchase or pool loan portfolios from smaller regional and community banks. Another possible avenue could be some type of "syndicated securitization" on the part of community banks, maybe put together by an investment bank.

In the past few years, Lehman Brothers, Inc. has opened a correspondent channel that gives it access to jumbo loans originated through the Internet. Through a partnership with HomeAdvisor Technologies Inc., Wendover Financial Services, and Freddie Mac, Lehman is buying jumbo loans of up to $650,000 as well as some subprime products. Lehman then pools the loans into securitizations. This underscores a major benefit from the use of middle-market securitizations: trading profits. A bank can originate a middle-market loan and then sell it to the structure for a gain. This is not unlike the "finder's fees" that are being paid to financial firms that locate potential trust-preferred investments to fill CDOs of bank-trust-preferred assets. These opportunities abound as banks often price loans related to their funding source and not to the market price.

Regardless of the pooling method, the investment bank puts together an SPE that contains the granularity and diversification needed to hedge the risk to both the buyers and the sellers. The investment bank could focus on a certain number of industries—perhaps 20 at the three-digit SIC code level. Additional diversification would be provided by geographic diversification. This diversification is conceptually the same as that for a credit card securitization. This vehicle would have a large number of loans with a cross-section of demographics to provide the granularity and the diversification of exposures needed to have a properly rated SPE. A CLO needs to be large in order for the net cash flows to exceed the costs of the structure. Generally, a deal needs to be $300-350 million in order to be viable. Given that middle-market loans need a diverse pool of assets, preferably with none larger than 2% of the total structure (50-100 loans), there is a necessity to find a tremendous source of assets.

The downside to this pool of loans from separate smaller banks would be the cost. For the investment bank, there would be costs involved in putting this structured vehicle together. But the investment bank will also have the ability to generate fees by buying loan portfolios at a discount from individual community banks and putting together a highly rated SPE. Naturally, this cost would be passed on to the smaller banks, in the form of factoring the "portfolio" of loans that they are selling.

SMALLER BANKS WOULD BENEFIT FROM MORE EFFECTIVE CAPITAL MANAGEMENT. BUYERS WOULD BENEFIT FROM HAVING AN EXCELLENT, HIGHLY RATED FIXED-INCOME SECURITY.

The benefits to the smaller banks, the sellers of the loans, would be more effective management of their economic and regulatory capital. In addition, they would be better able to manage such risks as idiosyncratic risk (risk unique to each borrower) and market risk (the risk that economic conditions will negatively affect the firm's ability to repay).

The benefits to the buyers will be that, if properly done, the SPE will provide an excellent fixed-income security that is highly rated. The SPE will represent the most basic ideas related to portfolio theory—that is, that a group of assets held together is less risky than the risks of the individual assets making up the portfolio.

The Long Road Ahead

In the near future, some middle-market securitizations will be done, but this will not be a large liquid market. Despite the attention they have recently received, structured financings using SPEs can be viable financial alternatives for middle-market loans. Once there is a larger market, it will allow for a better ratings system, as well as transparent pricing through better models. Better models will allow for tighter funding spreads providing a liquid market for these vehicles. To classify an SPE as a middle-market portfolio of high-yield loans, the spread over Treasurys should be approximately less than 1%, preferably around 50-75 basis points.

The best advice may be to keep in touch with lawyers, accountants, and other professional advisors as the accounting and legal standards and rules applicable to these transactions remain in flux. ❒

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Notes

1 Collateralized loan obligations (CLOs) are securities backed by a diversified portfolio of secured and unsecured commercial and industrial loans made by a financial institution.

2 "Default & Recovery Rates of Corporate Bond Issuers: A Statistical Review of Moody's Ratings Performance 1970-2001," Moody's Investor Service, February 2002, by David Hamilton

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Securitization is a well-established practice in the global debt capital markets. And while the market in structured finance securities was hit hard by the 2007â€“2008 financial crisisâ€”when investors shunned asset-backed securitiesâ€”interest in securitization has resumed as the global economy recovers. The Mechanics of Securitization is an accessible and practitioner-oriented look into what is required to successfully structure and close asset-backed security transactions in today's complex financial markets.Â The Mechanics of Securitization describes the process of structuring and executing an asset-backed security transaction, including the rating agency issues and legal review requirements associated with it.