MBSs — A BALANCE-SHEET QUESTION

HOW SECURITISED ASSETS AFFECT THE NUMBERS

The securitisation of assets, and in particular the securitisation or collateralisation of mortgages, has been used as a financing technique in the US for several years and has recently been gaining impetus in the United Kingdom and Australia.

In Australia, as already indicated by a JASSA contributor, securitisation has made a significant impact and is showing good growth potential as the financial sector becomes more informed about its nature and benefits. As more financial institutions enter the securitisation market, the implications for financial reporting and financial statement analysis will become increasingly important.

The securitisation process

Securitisation is the process of packaging and selling assets as securities: turning them into marketable instruments which can be traded on the capital market. The returns on the security are dependent on the returns on the related asset so, unlike conventional securities or notes, the life of the security and the life of the asset are inextricably linked.

The process of securitising an asset involves four parties:

- an originator or owner of the asset;
- the issuer of the security;
- an administrator or servicer of the securitised asset; and
- a trustee to ensure compliance with the terms of the issue.

In principle, any asset can be securitised, but the characteristics of financial assets make them particularly easy to securitise and market, since they usually have well-defined cashflows and determinable returns. This is particularly true of mortgages.

The originator of mortgage-backed securities (MBSs) is the company initiating the loan to the original borrower. Most originators of MBSs in the UK so far have been “new lenders” or “special-purpose mortgage lenders” — non-deposit-taking institutions which fund the loans on the wholesale market. The originator may in principle be the issuer of the security, but in the UK transactions have involved the use of a separate special-purpose company as issuer.

The originator of the mortgages transfers a portfolio of mortgage receivables to the issuer. The issuer then issues notes which are secured on the mortgages, using the proceeds to finance the purchase of the portfolio of mortgages from the originator. The initial effect of securitisation of mortgages in this way is to remove the asset from the balance sheet of the originator and replace it with cash, as with a sale.

The originator typically adopts the function of administrator and thus retains an important role by managing the initial mortgages and

Margaret Buchan is a lecturer in accounting at James Cook University of North Queensland. She was engaged in research into the securitisation of mortgages while a research fellow at the International Centre for Research in Accounting, Lancaster University, Lancaster, UK.
ensuring that the issuer has sufficient cash to make all interest and principal payments on the securities.

The issuer is usually a listed company formed specifically to issue the notes on a thinly-capitalised basis. The terms of the issue generally prohibit the issuer from engaging in normal business activities, such as employing staff and owning equipment and premises. The principal assets of the issuer are the portfolio of residential mortgage loans and various related insurance policies pledged as security for the notes.

The trustee is usually a deposit-taking commercial bank that oversees the assets of the issuer and enforces compliance with the terms of the trust deed.

The ownership structure embodying the securitisation transaction is critical to the effect on financial statements. Ownership is generally devised so that the originator avoids consolidation of the issuer.

In some instances, the issuer is a wholly-owned subsidiary of a related company of the originator. In other instances, there is no ownership connection at all; the issuer is owned by a discretionary trust. However, in all instances, careful examination of the offer documents of the MBSs reveals either implicit or explicit guarantees between the originator and the issuer. It appears that in most circumstances the originator retains the ultimate benefits and responsibilities associated with the underlying mortgage assets and the MBS liability.

At least 15 UK companies have issued MBSs through 49 related entities and subsequently removed the mortgage assets and related securities from the balance sheet, while retaining at least some of the associated benefits and risks.

The ownership structure used by National Home Loans PLC (NHL, the first UK company to enter the securitisation market) is one example.

The issuer, NHL First Funding PLC (First Funding), is a wholly owned subsidiary of Holdings Ltd, which under UK law is a related company of NHL PLC. Holdings Ltd has share capital of 100 ordinary shares, 400 preferred ordinary shares and 500 5 per cent non-cumulative preference shares.

The ordinary shares and preferred ordinary shares are held by NHL while the non-cumulative preference shares are held by Eagle Star Trust Coy in a discretionary trust. Holdings Ltd has four directors, two of whom are directors of NHL. These two directors have greater power than the others, so that NHL controls the voting. The originator, NHL, undoubtedly controls the activities of the issuer, First Funding, but under the applicable corporate and accounting regulations was not required to consolidate the accounts of First Funding into its group accounts. (Recent amendments to UK law emphasise the control element in determining the consolidation of a subsidiary company and are intended to alter this situation.)

The structure protects the interests of the MBS holders by ensuring that the cashflows from the mortgage receivables can service the securities without delay or impairment. Safeguards include the establishment of contingency funds by the originator; guarantees by the originator to cover short-term liquidity when interest receivable and interest payable do not match; and other guarantees, such as interest-rate swap agreements and subordinated loan agreements, to make good shortfalls caused by long-term changes in interest rates.

Some securities are also backed by mortgage pool indemnity insurance to guarantee the repayment of principal, and usually by insurance to cover the timely payment of interest.

The securities may be either floating-rate notes or fixed-rate notes. Only two fixed-rate MBS issues have been made so far in the UK. The others have been sterling floating-rate notes with interest rates paid (and reset) quarterly at a given margin above LIBOR London Inter-Bank Offer Rate.

Many of the issues contain provisions to increase the interest-rate margin over LIBOR later in the life of the security. This is to compensate the investor if the MBSs take longer than expected to mature, since the repayment of the principal is dependent on the rate at which the original mortgage borrower repays the mortgage, and is estimated on the basis of average repayment periods and early repayment of mortgages by borrowers.

Table 1 shows the development of MBS issues from 1987 to 1989 inclusive. The market started in the UK in 1987 and by 1989 totalled more than £6 billion. The decline in the average margin over LIBOR is consistent with increased efficiency in contract specifications limiting the risk of the MBS and with the increase in secondary-market prices.

**Why securitise?**

In the UK, there are barriers to entry to the home mortgage lending industry. MBSs provide a means by which investors other than building societies and banks can invest in the home-loans market on effectively the same terms. This has led to significant demand for MBSs from overseas banks and corporations wishing to benefit from the buoyant mortgage market.

In addition, tight fiscal policy in the UK has resulted in a dwindling supply of "gilts" or government-issued securities. The need for other forms of riskless investments has stimulated demand for MBSs.

MBSs are attractive to certain investors for a number of reasons. The Bank of England requires the equity capital of banks to be at least 8 per cent of risk-adjusted assets. In determining the risk of MBSs, the bank in 1986 granted them a weighting of 50 per cent (compared with 100 per cent for corporate debt).

Banks could therefore "release" capital by switching from high-weighted assets (corporate debt) to lower-weighted assets (MBSs) which had better risk-return characteristics. Most reasons given by UK insti-

---

**TABLE 1: MORTGAGE-BACKED SECURITY ISSUES IN THE UK**

<table>
<thead>
<tr>
<th>Year</th>
<th>Par value of issue</th>
<th>No. of issues</th>
<th>Average size</th>
<th>Average over LIBOR*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>1000</td>
<td>9</td>
<td>16.67</td>
<td>0.3000%</td>
</tr>
<tr>
<td>1988</td>
<td>3179</td>
<td>19</td>
<td>167.31</td>
<td>0.3236%</td>
</tr>
<tr>
<td>1989</td>
<td>1985</td>
<td>12</td>
<td>165.42</td>
<td>0.1698%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>6164</td>
<td>40</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* All issues except the first two in 1987 provide for the margin over LIBOR to increase to either 0.40 per cent or 0.50 per cent after approximately 10 years.
solutions for entering into securitisation can be categorised as constraint motives, asset-structure motives, or fee-income motives.

The activities of financial institutions, including mortgage-lenders, are constrained both by legislated prudential requirements and by debt covenants imposed by debenture trust deeds.

The desire to avoid these constraints — which may restrict an institution's growth and investment opportunities — is likely to encourage the use of transactions which reduce reported leverage and increase reported profitability.

Securitisation enables companies to streamline their balance sheets and expand their financing activities without expanding their recorded debt. The securitisation of mortgages through a related company enables an originator to borrow up to 100 per cent of the face (or book) value of the underlying mortgages without any deterioration in its reported leverage. The following example of securitisation by NHL illustrates how the procedure can increase the debt capacity of an originator.

Statements appearing in the annual reports of most originators emphasise the fee-generating aspect of the sale of mortgages to third parties. The separation of loan-funding activities from credit-risk evaluation and loan-servicing enables the originator to earn fee income and interest on the new mortgages without placing assets or liabilities on the balance sheet. This, in turn, improves the reported rate of return on assets.

### The NHL example

The effect of securitisation of mortgages through a related company can be illustrated by examining the report of National Home Loans PLC. In 1987 a mortgage portfolio of £50 million was sold to a related company, NHL First Funding Corporation PLC.

To demonstrate the effect of this transaction, the accounts of NHL and First Funding for 1987 have been consolidated and the capital and income gearing ratios compared. Although NHL holds only 50 per cent of the share capital of Holdings Ltd, the accounts are consolidated as for a wholly-owned subsidiary, as a review of the corporate structure indicates that no external equity has been injected into First Funding.

The effect of bringing the funding on to the balance sheet is indicated in Table 2. Column A shows the capital and income gearing of NHL when the financing activities of First Funding are kept off-balance-sheet; column B shows the gearing levels if the activities are included in the group accounts.

Although all ratios deteriorated when the £50 million funding was brought on-balance-sheet, the change in capital gearing ratios appears to be marginal. The change in income gearing measures is more noticeable.

Since 1987, National Home Loans Corporation PLC has funded a further £765 million off-balance-sheet by securitisation of mortgages. A further £65.95 million of MBSs were issued by related companies of NHL but were junior-ranked securities which were purchased by NHL to reduce the risk of the concurrently issued MBSs. An additional £228 million was raised off-balance-sheet by loan sales, with a further £260 million under negotiation at the time of publication of the report and accounts. The combined effect of these off-balance-sheet financings of £1,253 million will considerably compound the reported effect of the single securitisation of £50 million.

To assess corporate performance effectively, the analyst must consider carefully the implications of cross-guarantees and ownership structure. Originator-company guarantees may take the form of interest-rate swap agreements, subordinate loan capital or temporary funding. If ownership is structured to avoid consolidation, the originator may not be reporting all true obligations.

The effect of the implicit guarantees is to increase the risk of the investment for both current shareholders and current debt holders of the corporation. In addition, the involvement in the securitisation process may further expose the corporation to the risk of changes in the home-loan market.

Further, the performance of management, based on conventional asset-return measures may be overestimated if “ownership” of the mortgage portfolio essentially remains with the originator. (In some transactions only “beneficial” interest in the portfolio is sold to the issuer.) If a large portion of the revenue-generating assets is omitted from the balance sheet, the reported return on assets will be overstated. When comparing the companies’ management performance it is important to include all assets and equity under their control.

MBSs are only one form of off-balance-sheet financing in only one industry area — the financial sector. Similar benefits to those described here can be obtained by corporations outside the financial sector. The issue raises questions about the economic effect of the transactions on corporate investors as well as on corporate disclosure.

**NOTES**

2. MBS issues subsequent to 1989 show a widening of margins, believed to result from increasing fears over rising mortgage arrears (Barings Review of UK Mortgage-Backed Securities Market, October 1990).
3. From January 1992 the MBSs will attract a weighting of 100 per cent.