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# The Structured Finance Market: An Investor's Perspective

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## Abstract

The largest sector of the U.S. investment-grade fixed-income market is structured products—mortgage-backed securities and asset-backed securities. Issues and challenges currently facing investors who participate in this market sector include legal issues (e.g., consumer lending legislation), market structure (e.g., the role of the government-sponsored enterprises), and analytical methods (e.g., prepayment modeling). An important current concern is the need for education and training in the structured products area—particularly for investment policy compliance staff and for equity analysts.

Asset-backed securities (ABS) are an alternative to traditional bond financing. In contrast to a traditional secured bond, with an ABS, the burden for repayment shifts from the cash flow of the issuer to the cash flow of the pool of loans or receivables

and/or a third party that guarantees the debt payments if the pool of assets does not generate sufficient cash flow. The largest type of asset that has been securitized is mortgage loans (residential and commercial), which are referred to as mortgage-backed securities (MBS). Collectively, ABS and MBS are referred to as “structured products,” and as of the end of 2004, these securities represented about 40 percent of a broad-based investment-grade U.S. bond index and slightly more than half of the investment-grade products in the same index.

Starting with a brief discussion of why asset securitization has been a major financial innovation, the article discusses current issues and challenges investors who participate in this market sector face-legal issues, questions of market structure, and analytical issues. Legal risk is a major concern to investors in the structured products market and represents the greatest threat to the growth of this sector of the bond market. The most critical issue is the long-standing view that investors in a structured product are protected from the creditors of the seller of the collateral because of the so-called bankruptcy remote trust/true sale opinion. In this concept, when the seller of the collateral transfers it to the trust (a special-purpose vehicle), the transfer represents a “true sale”; therefore, in the case of the seller's bankruptcy, the bankruptcy court cannot penetrate the trust to recover the collateral or cash flow from the collateral. The bankruptcy remote trust/true sale opinion has never, however, been fully tested.

Issues related to the market's structure are the role of the Government National Mortgage Association and two government-sponsored enterprises, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation; the survival of the “to be announced” market (an important market innovation that works like a forward contract and has fostered the development of the fixed-rate agency pass-through security market); corporate issues masquerading as securitizations; the role of the servicer/trustee; and the increased use of derivatives (including credit default swaps and the relatively new prepayment derivatives). These issues all have an impact on valuation and trading strategies in the structured finance market.

The analytical issues and challenges facing today's investors are valuation (including prepayment modeling and credit-risk modeling), risk measurement, and the management of structured products. Prepayment modeling is an ongoing analytical challenge in the MBS area. MBS valuation and the measurement of MBS interest rate risk (duration, convexity, and key-rate duration) require the projection of the collateral's

cash flow, and the cash flow itself depends on the prepayment forecast. Projecting cash flows for structured products typically requires projections of the default rate, the timing of defaults, and the recovery rate. Default modeling for structured products is in its infancy. Portfolio managers whose mandate is to outperform a broad-based bond index face the problem of constructing a portfolio that has the desired tracking error vis-à-vis the agency pass-through sector of a bond index. Unlike replicating the U.S. Treasury, agency, and credit sectors of a bond index, replicating the pass-through sector is fraught with difficulties.

Finally, the article addresses two groups of investment professionals who are badly in need of education and training in structured finance—compliance staff and equity analysts.

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