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REFLECTIONS

The Structured Finance Market: An Investor's Perspective

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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
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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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