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Credit FAQ:

The Basics Of Credit Enhancement In Securitizations

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Credit FAQ:

The Basics Of Credit Enhancement In Securitizations

Over the course of the past year, Standard & Poor's Ratings Services has received inquiries regarding the process of assigning ratings in structured finance transactions. One concept that's key to understanding how we rate securitizations is credit enhancement. Credit enhancement helps to protect a transaction against potential losses in the underlying assets. The following are frequently asked questions about credit enhancement, along with our answers.

Frequently Asked Questions

What is credit enhancement?

Credit enhancement (or credit support) is a risk-reduction technique that provides protection, in the form of financial support, to cover losses under stressed scenarios. Think of credit enhancement as a kind of financial cushion that allows securities backed by a pool of collateral (such as mortgages or credit card receivables) to absorb losses from defaults on the underlying loans. Thus, it's not the case that through securitization, poor credit assets somehow "transform" into solid investments; instead, credit enhancement helps to offset potential losses. Credit enhancement is used in project financings, public-private partnership transactions, and structured finance to help mitigate risk for the investors, and has been an accepted practice in bond financing for more than two decades.

What methods do transactions use to enhance credit, and how do they work?

There are several methods of credit enhancement, and it's not uncommon to see more than one type in a single structured finance transaction. The most common forms are subordination, overcollateralization, and excess spread.

Subordination

Subordination is the process of prioritizing the order in which mortgage loan losses are allocated to the various layers of bonds so that the lower rated junior bonds serve as credit support for the higher rated senior bonds. More specifically, all principal losses on the underlying mortgages go to the most junior bonds first, resulting in a write-down of their principal balance. Similarly, any interest shortfalls will affect the most junior bonds first.

Overcollateralization

Under the overcollateralization method, the face value of the underlying loan pool is larger than the par value of the issued bonds. So even if some of the payments from the underlying loans are late or default, the transaction may still pay principal and interest payments on the bonds. (see chart).

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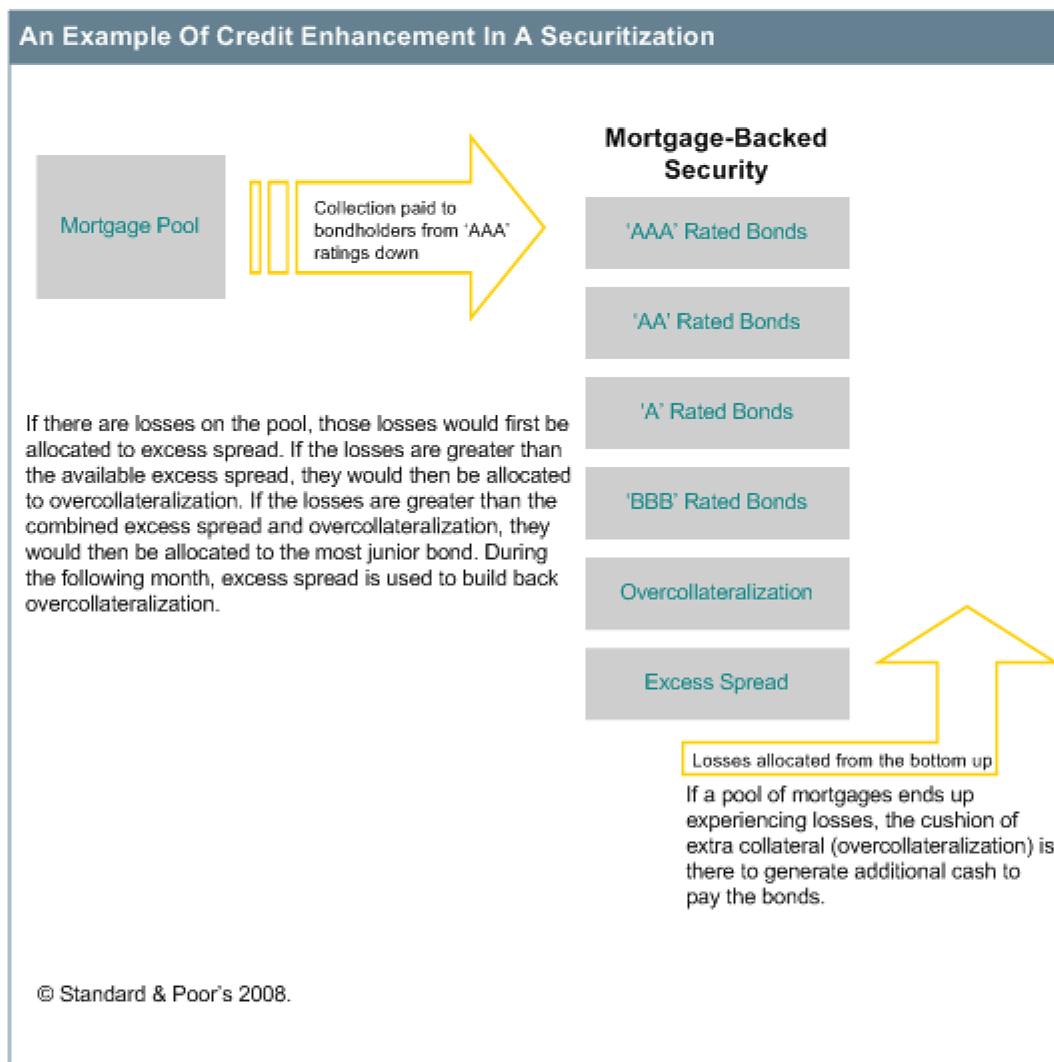

For example, if our analysis of a particular collateral pool's expected performance indicates that the pool would need 40% credit enhancement to support a 'AAA' rating, that rating could not be obtained unless the transaction had 40% more collateral above and beyond the par value of the securities issued. So if the collateral pool was $2.0 million, it could only issue $1.2 million in 'AAA' rated securities. If the collateral performs poorly—for example, by incurring 30% losses—it would still leave a cushion of 10% to cover losses from further defaults. So here, there is no "transformation" of poor credit assets into solid investments; instead, in our example, a transaction has $2.0 million in collateral to support $1.2 million in 'AAA' rated securities.

Excess spread

Excess spread is the additional revenue generated by the difference between the coupon on the underlying collateral (such as a mortgage interest rate) and the coupon payable on the securities.

For example, borrowers whose mortgages are in a given collateral pool may be paying 7% interest, while the coupon of the mortgage-backed security may be 4%. The transaction can then use the excess spread to absorb collateral losses or build overcollateralization to its target level. However, generally speaking, once the transaction has used the excess spread to cover losses for that month, whatever monthly excess spread it doesn't need to build to

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the overcollateralization target is allocated to a residual certificate.

Whatever method a transaction uses, credit enhancement allows for more resources or financial backing for a security than would be available from the underlying assets alone. That way, if the pool ends up experiencing losses, the credit enhancement supporting the bonds should still provide enough cushion in the transaction to allow for payment to the bonds. Because it provides a kind of safety net, credit enhancement increases the likelihood that bonds with a higher payment priority (senior bonds) will receive their full repayment of principal and timely interest.

What determines the amount of credit enhancement a transaction needs?

The amount of credit enhancement that is appropriate for each specific transaction depends on many variables. Standard & Poor's assumptions for calculating the effect of credit enhancement are published and updated regularly, and are available on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at www.ratingsdirect.com. They're also available on our Web site at www.standardandpoors.com.

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