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Securitisation

Mortgage securitisation is the process whereby a pool of home loans are packaged together and sold as financial instruments into the capital markets. The interest payments and capital repayment form the basis of the value and security of the instrument. In this way, a home loan provider is able to raise the money required to finance its loans, without having to take deposits.

For example, a home loan provider is going to make 10 mortgages to home buyers in South Africa. Each mortgage has a 20 year term, is worth R2 million and pays a fixed interest rate of 10%. The home loan provider therefore has an asset that comprises the interest payments over 20 years (R2 million each year), plus the capital repayments in 20 years time (R20 million).

Through securitisation this asset can be sold to investors in the domestic and international capital markets. Its value will be determined by a combination of the net present value of the mortgage cashflows, and an assessment of the risk of the mortgages. Through this process, home loan providers are able to raise money today, on the back of promised payments in the future.

Such securitisation began with the financing of mortgage pools in the 1970s in the United States. For decades before that, building society or saving and loans were essentially term lenders; they held loans until they matured or were paid off. These loans were funded principally by deposits, and sometimes by short term debt, which was a direct obligation of the funder. But after World War II, banks simply could not keep pace with the rising demand for housing loans, and therefore other sources of finance were required. The market grew rapidly in the US and soon travelled abroad as both investors and lenders saw advantages in the process.

Securitisation came relatively late to South Africa (first issuance was in 2000), mainly due to the fact that for historical and exchange control reasons the debt capital markets remained small and isolated to international developments. However, over the last 7 years South Africa's markets have grown significantly and are now believed to be the 6th most liquid in the world. This has opened up the securitisation market which has grown from around R6.5bn in 2001 to over R86.7bn in August 2007. (Source: Investec) Theoretically any type of loan (auto loans, student loans, credit card receivables) can be repackaged in such a manner but investors generally favor securities backed by property (RMBS) as they are considered less likely to default and in the event of a default the funder has access to the underlying property as collateral.

For lenders, the primary advantage is that securitisation reduces the cost of funding, which in turn benefits the home buyer as interest rates on mortgages come down. Securitisation also more closely matches both the term of the underlying mortgage with that of the security, thereby reducing funding mismatches. For investors, they have access to a financial instrument that provides a relatively high rate of return when compared to cash, equities or traditional debt instruments, and that also create greater portfolio diversification for them.