RATING MIGRATION AND ASSET CORRELATION BY ASTRID VAN LANDSCHOOT AND NORBERT JOBST pdf

1: CREDIT Conference - Programme

Arnaud de Servigny; Norbert Jobst [eds.] Year of publication: c

Then, they can model how their current at the peak of the market portfolio will react to different levels of market downturn and determine what is the acceptable credit and marked-to-market loss they can bear. Furthermore, investors can anticipate the evolution of their portfolio between today and some future point [factoring WAL Weighted Average Loss scheduled and unscheduled amortization, expected losses, etc. Finally, investors must consider what steps to take now and in the near future to bring their current portfolio to that which is sensitive to credit and MTM losses and is consistent with their own institutional or personal tolerance. We highlight a number of criteria in no particular order: Granularity Granular deals with strong credit quality are less susceptible to event risk of single-name exposures than nongranular deals. Historical evidence suggests that more granular, high quality ABS have experienced little spread volatility compared with low quality granular deals and nongranular deals. These observations are true across ABS capital structures. While correct, this outcome may be influenced by the fact that granular deals in general are associated with consumer exposures and nongranular dealsâ€"with corporate exposures. That may be also associated with the granularity of the portfolios as mentioned earlier. Overview of the Structured Credit Markets 17 In addition, consumer portfolios are exposed more to systemic risk, say widespread economic deterioration, than to event risk collapse of a single company or an industrial sector. We caution, however, that today, in most countries, the consumer is over-indebted, i. The two countries, which in the past downturns have had relatively high consumer indebtednessâ€" United States and UK, are even more indebted today, with the consumer debt stretching beyond residential mortgage debt. Consumer lending and spending softened the blow during the last downturnâ€"this buffer may not be as readily available in a future downturn. Hence, the economy as a whole and the consumer pools, in particular, may suffer more than previous downturns in history. Senior versus Junior Tranches It is a fact that senior tranches have more cushion against credit deterioration than junior tranches. The former seems to hold true for different asset classes, even ones of similar granularity. An interesting way to look at the credit cushion is to compare the level of credit enhancement for each tranche to the level of five-year cumulative losses of a given asset class. The challenge arises, when such cumulative loss numbers are not robust, statistically speaking. As mentioned earlier, senior tranches tend to experience less spread volatility than junior tranches of the same asset class. Their bid-offer spread is much lower than the one for junior tranches. Almost always senior tranches are more liquid than junior tranches of the same deal. It is not uncommon for market participants to often use secondary tradebased pricing for marking-to-market their senior tranche positions and estimated pricing on the basis of primary market or dealer talk for mezzanine positions. In the case of the latter, there is the risk that one-off trade may lead to serious repricing and mark-to-market volatility. These linkages may have both direct and indirect effect on the bond pricing on the secondary market, and understanding the potential 18 CHAPTER 1 for problems from that corner is crucial in defending against mark-tomarket losses, defaults or downgrades. In addition, idiosyncratic aspects of underwriting and servicing should be taken into account in determining future pool performanceâ€" this is particularly true for subprime and commercial real estate sectors. Nonbank, nonrated servicers are of particular concern when anticipating the performance of the securitized pools and the headline risk of the respective bonds. High versus Low Leverage Positions In a low spread, low default market environment, leverage is a necessary way of achieving yield. In the course of the last couple years, investors had to take leverage to achieve their yield targets. The discussion about what leverage is in structured finance, how to estimate it, etc. What is clear, though, is that leverage can enhance returns in good times and magnify losses in bad times. Hence, there is a need to review the amount of leverage, how it is achieved, and the extent to which it can be detrimental to the portfolio performance in a market downturn. Investors need to differentiate between de-levering structures say, an MBS and those that are meant to remain fully levered for life say, a CDO Squared. Pool versus Single-Name Exposures While this may seem as a repetition of the granularity argument, it is not necessarily so. Single-name exposure may have many different connotations: The need to estimate the accumulation of multiple exposures to a single name under different transactions is obvious, but the estimate is not that simple to make in practice. We suggest going beyond the issue of overlap, as know from CDO land, and considering all forms of exposure or potential exposure to a given name present in the structured finance portfolio. BIS2 risk weights favor all senior securitization exposures and do not favor all subinvestment grade securitization exposures. Investors should factor the Overview of the Structured Credit Markets 19 lower and higher capital requirements post January 1, , when determining the adequate price for a securitization bonds, scheduled to mature after We also note the granularity adjustment differentiation for senior tranches of securitization exposures. Other Country-Specific Considerations Such considerations, e. That may make CMBS rarer, on one hand, and improve the property values for existing deals, on the other. In the short-term, this is offset by the growth in real estate conduits. The introduction of covered bonds in more countries should reduce the supply of MBS and make them more attractive. The reduction of budget support for SMEs in Spain should reduce their supply, change their geographic diversity, or convert them into stand-alone structures with higher subordination levels more supply of non-triple-A paper. We certainly do not intend an exhaustive list here, but suggest that investors consider these changes and how they could affect future supply and pricing in specific structured finance sectors. Modeling Structured finance securities are complex credit structures, which can perform differently under similar economic and market scenarios. All the more, when addressing the need to fully understand the variations in their performance, modeling comes handy. In that regard, availability of models and people able to use them properly becomes a key factor in better understanding the future performance of structured finance deals and related portfolios. The preceding discussion indicates that the simply rerunning historical scenarios are not enough for investors to fully understand the risk credit, MTM, duration of their holdings. One needs not only modellers, but also credit-savvy ones at that. Increase Asset-Based Liquidity of the Portfolio In a market downturn scenario the need for liquidity in a portfolio is most acutely felt, especially one with margin calls or with a potential for money withdrawals at a short notice. In that regard, we suggest that investors 20 CHAPTER 1 use the rating agencies guidelines for liquidity eligibility and haircuts for different asset classes of structured finance securities, in determining the asset-based liquidity of structured investment vehicles. Regulatory guidelines for repo eligibility and haircuts can also be useful, although the list of such securities is limited to primarily senior tranches of ABS backed by granular pools. Alternatively, high quality consumer-related ABS seems to be more cycle-neutral than low-credit-quality consumer-pool ABS. We refer here to the cyclical nature of the exposures comprising the pool of the respective structured financing. Similarly, the performance of a subprime mortgage pool will be dependent on the performance of the economy and the housing market hence, its cyclical nature , but modified by the actions of the respective servicer. Senior Mezzanine-Equity Positions That the credit risk and mark-to-market risk of the different tranches of structured financings are different is a given. What is more important is that such differences persist across the tranches of different asset classes, so the equity position of a CDO of senior ABS will have different susceptibility to the earlier risks than, say, the equity position of a CDO of highyield loans, not to mention the mezzanine of prime mortgage master trust MBS compared to the mezzanine of a residential real estate mezzanine CDO, or the senior tranche of stand-alone amortizing Dutch prime MBS in comparison with senior tranche of a mixed lease Italian ABS. We explored some of the markto-market aspects earlier, and we turn our attention now to some of the more fundamental changes we anticipate BIS2 implementation will prompt. We note that the number of banks expected to adopt the IRB Internal Rating Based approach is high in Europe, making this approach dominant in determining risk capital and the BIS2 impact in securitization. The chart above is based on QIS3 data and broadly indicates that banks will have reduced incentive to securitize consumer assets, and increased incentive to securitize special lending exposures, sovereign and to some degree other banks. That is because BIS2 leads to significant reduction in risk weights for retail exposures, particularly mortgages, and an increase in risk weights for specialized lending and sovereigns, particularly high volatility real estate. In more specific terms: The incentive should shift toward the securitization of higherrisk weighted assets such as lower investment and subinvestment grade corporate exposures, commercial real estate, specialized lending, etc. Securitization of mortgage and retail portfolios should be driven more by nonregulated companies, as well as by the funding considerations of banks. These conclusions, however, should be further detailed on the basis of the credit quality of the underlying exposures, subject to securitization. The chart below compares the capital requirements for different types of retail exposures under both standardized and the IRB approaches. To simplify, it will depend on whether the capital before securitization is higher, equal, or less than the equity piece of the securitization transactions, which is usually the piece retained by the bank originator. In that respect, we note the wide range of corporate exposures listed under the IRB approach and the potential difficulty for banks to get supervisory approval to use their own inputs for capital calculation. That may lead the banks to use the prescribed risk weightings for specialized lending, as indicated in the discussion of IRB, and thus have regulatory capital incentives to securitize such exposures. Banks who continue to dominate the issuance volume of structured products may modify their issuance patterns, as a result of incorporating regulatory capital treatment of the underlying exposures in the economics equation of securitization. Securitization of mortgages may be primarily done for funding purposes, given limited regulatory capital benefit for it, whereas securitization of commercial real estate, unsecured consumer loans, and project finance may be driven by regulatory capital relief considerations in the first place. Alternatively, banks using the standardized approach may still have a regulatory capital benefit from securitization, while that benefit will be largely unavailable for banks applying the IRB approach. All this could lead to a change in supply levels, types of products securitized, and servicer considerations. To achieve better realignment of regulatory and economic capital, banks may be tempted to issue also double-Bs and single-Bs, and even sell first loss positions. From the Perspective of the Investing Bank An investing bank naturally takes into account the cost of regulatory capital among other things when determining its investment interest in a Overview of the Structured Credit Markets 23 securitization position. Again from the perspective of regulatory capital considerations alone, a bank investor should: The placement of subordinated tranches may become more dependent on the appetite of nonregulated investors. In fact, the question of placement of noninvestment grade tranches of securitizations will become a key factor in determining the viability of many future securitization transactions. This creates even bigger disincentives for IRB banks to invest in subordinated securitization exposures and make them choose instead high-yield corporate exposures. Given the reduced risk weights for senior tranches under BIS2, banks are expected to realize certain savings from holding such securitization positions. Given that banks are the dominant investors in securitization in Europe, it is highly likely that such savings are passed on to the market in the form of spread tightening. Those savings, which can be viewed as a potential range of spread tightening for securitization exposures. That will translate into 40 bps savings on average cost of capital. Those savings can be passed on to the market in the form of spread tightening, although that will not be a onefor-one transfer. The increase in its regulatory capital is bps, which in turn should see respective widening of the BB spreads of such exposure, to compensate the bank for the increased regulatory capital. Demandâ€”Supply Dynamics From the perspective of the demandâ€”supply dynamics of the securitization market, our conclusions can be further expanded: In addition, there will be differentiation of the incentives to securitize by asset class or at all across banks depending on the approach to regulatory capital they adopt. Spreads on subinvestment grade securitization tranches should widen, and on senior tranches should tighten, compared to present levels, although it is difficult to anticipate the changes in the overall cost of securitization, as the earlier movements may or may not be netted out. The spread movements of securitization tranches in comparison to similarly rated corporate exposures is somewhat less certain, although we would expect noninvestment grade securitization tranches to widen more than similarly rated corporate exposures. We expect ratings to continue to play a major role in the securitization market, probably more so than in the corporate market. Hence, while this may be the end of securitization, as

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we know it, it may be the beginning of a new stage of securitization and structured market development. Given that banks and related conduits account for two-thirds roughly of securitization paper placed on the market, it is conceivable that lower-risk weights should translate into lower-target spreads for such holdings. The potential for significantly lower-risk weights for senior tranches may be fuelling demand for them in expectation for spread tightening, as those weights are introduced or less spread widening if their introduction coincides with a softening market: As a result, they may be more likely to sell upon a downgrade. One is the change in accounting practices, the other is the introduction of regulatory capital requirements for insurance companies and pension funds, loosely tailored after BIS1 rather than BIS2. The accounting changes strike at the heart of securitization practices, affecting off-balance sheet treatment of securitization, accounting for securitization exposures, etc. Given the uncertainty about the final resolution of numerous points here below we highlight only one of themâ€” the accounting for synthetic securitizations. Solvency2, on the other hand, is an exercise similar to the introduction of BIS1 years ago and could change the way insurance companies and pension funds go about doing their business in the future.

2: Citations of A Markov Model for the Term Structure of Credit Risk Spreads

Overview of the structured credit markets by Alexander Batchvarov --Univariate risk assessment by Arnaud de Servigny and Sven Sandow --Univariate credit risk pricing by Arnaud de Servigny and Philippe Henrotte --Modeling credit dependency by Arnaud de Servigny --Rating migration and asset correlation by Astrid van Landschoot and Norbert Jobst.

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Relazione invitata: Default Correlation, Cluster Dynamics and Single Names: The GPCL Dynamical Loss Model, Damiano Brigo (DerivativeFitch / QFR - Fitch Ratings, Londra) Asset Correlation in Structured Finance Portfolios, Astrid Van Landschoot (Standard & Poor's, Londra).

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