The Journal of Structured Finance

VOLUME 14, NUMBER 3 FALL 2008

Once again, we start our issue with an article on structured finance issues related to the current credit crisis. Jerry Fons describes the conflicts of interest inherent in the credit rating agencies' issuer-pays business model and the need for more competition in the credit rating business, which will not be possible until issuers of structured securities are required to provide sufficient transparency in the details of underlying collateral so that any credit rating agency can do the required analysis to offer an unsolicited opinion. Mr. Fons made similar points in his testimony before the U.S. House Committee on Oversight and Government Reform in a hearing on October 22 concerning the role of the rating agencies in the current financial crisis. Next we have two articles on mortgage-backed securities. Anand Bhattacharya, Bill Berliner, and Frank Fabozzi provide a detailed technical analysis of how mortgage rates are determined based on capital market pricing, credit enhancement cost, and valuation of servicing assets; they then show us how a rate/point grid is determined, how credit enhancement and servicing costs are compared between the agency and private label market sectors, and how the risk-based pricing process works. Alex Levin describes a proprietary method for analyzing a portfolio of mortgage-backed securities (MBS) that reflects the continually changing dynamics of interest rates and home prices and a monthly updated delinquency composition; this method can be used to spot credit deterioration in advance of a credit rating agency downgrade and to assess the portfolio's credit risk in both loss levels and odds of occurrence. Then, closely related to MBS, Doug Lucas, Frank Fabozzi, Laurie Goodman, Andrea Montanari, and Armin Peter provide an introductory article on covered bonds, a form of financing in which mortgages and other loans remain on a bank balance sheet, collateralized by a "cover pool." The authors describe recent legislative and regulatory steps taken in the United States to get the covered bonds market started. They explain that covered bonds are not a panacea for recent problems with MBS but are still likely to occupy a niche in the market.

Hylton Heard and John Bella give us an update on auto loan ABS, recently the second-largest ABS class (behind credit cards) in issuance, through an analysis of the credit fundamentals that determine current auto loan ABS ratings. They point to increased net loss rates in the current economic environment. Martin Nance then gives us some insight into the credit derivatives market through a description of the "credit derivative product company" and the needs it satisfies, which include acting as credit backstops for dealers in credit default swaps and as counterparties to absorb banks' mark-to-market risk.

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Finally, we have a section of five articles that explain how securitization serves insurance companies' risk management and fund-raising needs. Ray Johnson and David Booysen explain the underpinnings of a life insurance company's business model, introduce us to life-linked financings, show how capital markets can be used to finance insurance company needs, and discuss the benefits and opportunities of life-linked investments for issuers and investors. Then Alison McKie shares another view of how the capital markets are used to absorb insurance and related financial market risks for an insurer or reinsurer; she describes three categories of life-insurance-linked securities: catastrophe cover; embedded value; and financing transactions, such as redundant reserve financing. Nick Potter and Michael McDonnell explain the legal structures for statutory reserve financings and embedded value monetizations, the two types of life-insurance-based securitization that have predominated in the market to date. Malcolm Wattman and Matthew Feig then explain how catastrophe bonds, or "cat bonds," provide reinsurance protection for natural catastrophe risks while also providing an important opportunity for investors to diversify away from credit and interest-rate risk. Finally, Morton Lane compares reinsurance in the capital markets with traditional reinsurance mechanisms; he explains why traditional reinsurers earn higher returns on capital but also why capital markets reinsurance is playing an important and growing role in the market.

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