A new business model for connecting borrowers, traditional lenders, investors and administrators could fuel growth in esoteric ABS.

The traditional Asset-Backed Securities (ABS) market is well established, and securitizations of credit card receivables and auto loans are common. Yet nearly a decade of low rates, slow global economic growth and challenging equity markets combined with the pervasive downturn in the emerging markets have kept investors constantly searching for alternative risk and yield strategies.

To this end, investor appetite for esoteric ABS has increased, and an array of guaranteed future cash flows are being securitized to meet the demand. Among them are loans and leases on aircraft, railcars, timeshares and containers, as well as small business loans, stranded assets, triple net leases, whole businesses, tax liens, single family rentals and solar generation. Recently, wireless carriers have begun securitizing their equipment installment plans as well.

Admittedly, there are some challenges associated with esoteric ABS. Sourcing new and different types of assets that possess predictable credit and cash flow characteristics is one. Another is the longer time it takes to market these securities to investors and secure ratings from the agencies, which may not be familiar with the underlying assets. Esoteric ABS are less liquid than traditional ABS. There are also valuation, legal, regulatory and risk assessment issues associated with them. For example, there is a lack of precedents in terms of legal recourse, investor demographics and resolution mechanics for these unique structures and counterparties.

For some investors, however, the performance track record of this asset class combined with the potential opportunity to earn higher yields justifies the risk. On the supply side, advancements in technology are presenting new opportunities to create, analyze, market, sell, securitize and process these complex assets efficiently.
TECHNOLOGY ENABLES GROWTH
Since the 1990s, ABS market participants have deployed sophisticated technology to structure deals and support all the processes in the transaction – from trade capture and risk management to back office confirmation, accounting and settlement. These systems eliminate manual processes, automate workflow and improve operational efficiency.

There are solutions that package data so ABS deals can be priced efficiently. Others are devoted to position keeping and the calculation of closing prices and value at risk. The technology is scalable to accommodate large positions and complex calculations, and sufficiently flexible to support rapid innovation and new product development, which is important for esoteric ABS.

Esoteric ABS structures are not necessarily more complicated than traditional ABS, but the documentation may be complex and pose unique operational dynamics across counterparties. Moreover, the risk profile varies considerably. For example, esoteric ABS transactions such as solar and cell towers have a relatively low correlation to macroeconomic conditions, offering the possibility to diversify, while others such as container leasing have a high correlation.

These mainstream tools and technologies of the 1990s and early 2000s will remain critical to traditional and esoteric ABS market participants. But now there is a keen focus on how the technologies of the future can increase efficiency and lower cost and risk even further. The next generation of tools now enable business users to analyze and model data themselves. Ultimately, this will make it faster to value esoteric ABS and assess the legal and regulatory requirements as well as the risk.

One example of a technology innovation that could enable growth in the esoteric ABS market is marketplace lending.

MARKETPLACE LENDING
The Internet, mobile technology, big data and cloud technology are fundamentally changing the way ABS are created, marketed, sold and processed. As traditional banks retreated from consumer lending, peer-to-peer platforms stepped in to fill the gap and satisfy pent up demand for credit by matching borrowers and lenders online and securitizing the loans.

Marketplace lending platforms leverage big data and analytics technology. Their consumer lending algorithms, for example, take into account factors ranging from credit scores to social media activity. In fact the use of advanced analytics is often cited as a strength because of its potential to reduce risk, whereas traditional securitizations rely heavily on credit scores.

Borrowers benefit from marketplace lending because they can often gain access to funds quickly and at lower interest rates than they can get from banks. Individual and institutional investors benefit as well because they can lend money at various interest rates based on proprietary credit scores assigned by each platform.

Proponents maintain that marketplace lending platforms increase efficiency, reduce costs and shorten the time to market. The transactions promote regular issuance and increase investor participation. Theoretically, the platforms should improve transparency and provide some momentum for marketplace loan ABS to become a mainstream investment product. This dynamic may have contributed to the recent growth in the origination of ABS backed by unsecured personal loans on these platforms.
On the other hand, marketplace lending is not as mature as other asset classes, so there is not much data to show how these loans perform over the long haul. There is continued due-diligence required on how documentation is delivered to the administrator. There is also a continued dialogue around the validity of credit algorithms and their ability to better protect borrowers.

While marketplace lending is poised to grow, some legal and regulatory considerations could challenge the securitization of this asset class. Notably, the U.S. Supreme Court has been asked to review the Madden vs. Midland Funding, LLC ruling. This case addresses the lawful interest rate a lender is allowed to charge, and what happens when debt is assigned by a national bank to an entity that is not a national bank. These issues will need to be resolved before marketplace lending is extended to include esoteric ABS.

PARTNER WITH AN EXPERT ADMINISTRATOR
From a broader perspective, marketplace lending illustrates how the technology industry has gotten closer to consumers and assets by developing platforms that collapse the complex layers of aggregation and analysis. Speed, simplicity and efficiency are critical to origination. These platforms enable consumer asset and personal data to be centralized and aggregated across customer sets, and then harnessed and processed quickly and efficiently.

Connecting technology to the complex needs of issuers, investors and market infrastructure is critical to the growth in esoteric ABS securitizations. It allows for tighter integration between origination and administration. However, it is also important for participants to work with an expert administrator that invests in state-of-the-art innovation centers worldwide and offers a broad suite of management and services covering the entire investment lifecycle. It is important that the administrator has a track record in both traditional and esoteric ABS, can scale globally, and has the ability to handle workouts should a default occur.

CONCLUSION
Low rates and tighter spreads in traditional ABS and investment-grade asset classes are attracting investors to esoteric ABS. Generally, investors worldwide are interested in diversifying their risk exposures, and they perceive the level of risk in esoteric ABS is acceptable given the potential for higher returns. Analysts expect the supply from existing and new issuers to increase and the number of private transactions to expand as the economy improves, employment increases and credit performance strengthens. Moreover, advancements in technology will support the market in numerous ways.

Esoteric ABS structures are complex and diverse. By partnering with an administrator that has the operational expertise, technology and resources to be efficient and responsive in due diligence, execution and delivery, issuers are well positioned to reap the potential benefits.

AUTHORS:
– Sonal Patel, Client and Business Development, BNY Mellon Corporate Trust
– Andrew Taylor, Group Manager, U.S. Product Management, BNY Mellon Corporate Trust
BNY MELLON IS YOUR STRATEGIC PARTNER, PROVIDING YOU SOLUTIONS IN A COMPLEX MARKETPLACE

– As the Investments Company for the world, delivering advanced technology solutions is a core competency and priority. Our goal is to help clients realize their full potential and power investment success by leveraging our distinctive expertise.

– Over one-third of our 50,000 strong global workforce are IT professionals.

– Our technology is an enormous asset that differentiates us in the global marketplace. With our on-going commitment to innovation, we are redefining what is possible and forging a new path in financial services.

– We have the global access, flexibility and breadth of capabilities to accelerate automation, improve productivity and enhance user experiences.