

AFIN8003 - Workshop 11

Banking and Financial Intermediation

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! Workshop 11: Loan sales and securitisation

This week a bank's loans leave its balance sheet. **Loan sales** hand a loan to a buyer; **securitisation** turns loans into securities. Today you use both, and compare them with a covered bond.

Plan for the hour:

1. Part A, Concept check (≈ 10 min). Eight MCQs. Self-mark.
2. Part B, Short answers (≈ 10 min). Two discussion questions.
3. Part C, Clearing the books, worked through (≈ 30 min). Three rounds, Monday to Wednesday. *This is the bulk of the workshop.*
4. Part D, The big question (≈ 10 min). Open discussion.

Bring a pen. Mark up the handout.

1 Part A: Concept check

1.1 MCQ

1. The **originate-to-distribute** model involves:
 - ☐ making loans and holding them until maturity
 - ☐ making loans, selling or securitising them, and using the proceeds to make new loans
 - ☐ making loans and keeping them on the balance sheet as collateral
 - ☐ buying loans from other banks and holding them until maturity
2. In a loan sale **without recourse**, the selling FI:
 - ☐ must buy the loan back if it defaults
 - ☐ has no explicit liability if the loan defaults
 - ☐ shares any default losses equally with the buyer
 - ☐ keeps the loan on its balance sheet
3. A leveraged loan trading at a bid price of **85 cents** per \$1 of par is:
 - ☐ nondistressed
 - ☐ distressed
 - ☐ investment grade
 - ☐ a traditional short-term loan
4. In a loan **participation**, the buyer:
 - ☐ holds a direct claim on the borrower
 - ☐ gains full control over the loan's terms
 - ☐ is exposed to both the borrower and the selling FI
 - ☐ replaces the seller in the original credit agreement
5. Which of the following is **not** a reason FIs sell loans?

- ☐ to earn fee income
- ☐ to reduce capital costs
- ☐ to improve liquidity
- ☐ to raise the deposit insurance cover on their deposits

6. The key difference between an **SPV** and an **SIV** is that:

- ☐ only an SIV is off the originating bank's balance sheet
- ☐ an SPV ceases to exist when its loans mature, while an SIV continues and funds its loans with short-term debt
- ☐ an SPV takes deposits and an SIV does not
- ☐ an SIV is protected by deposit insurance

7. In a sequential-pay **CMO**, prepayments in the early years go to:

- ☐ all classes in proportion to their size
- ☐ Class A, until it is fully repaid
- ☐ Class C first, as the longest class
- ☐ the originating bank

8. **Mortgage-backed bonds (MBBs)** and covered bonds differ from pass-throughs because they:

- ☐ give investors a fractional ownership share in the mortgage pool
- ☐ pass mortgage payments straight through to investors
- ☐ stay on the issuer's balance sheet, with the mortgages serving as collateral
- ☐ need no excess collateral

2 Part B: Short answer questions

2.1 Q1: SIVs and SPVs in 2007

In 2007 many SIVs collapsed, and Citigroup had to bring roughly US\$58 billion of SIV assets back onto its balance sheet. Securitisations done through SPVs did not face runs in the same way. Explain the difference.

2.2 Q2: Moving risk is not removing it

Loan sales and securitisation move credit risk off a bank's balance sheet. Use two examples from the lecture to show that the risk does not disappear.

3 Part C: Clearing the books, worked through

! The scenario

You work in the credit portfolio team at **Acacia Bank**, a mid-sized Australian ADI. Acacia's loan book has grown faster than planned. The Board wants to raise cash and free up capital without losing customers. You have three tools from the lecture: sell loans, securitise mortgages, and issue covered bonds. Work through the rounds in order.

i Reference: facts from the lecture

You are not expected to recall these. Use them.

- A leveraged loan is *distressed* if its bid price is below 90 cents per \$1 of par, or the borrower is in default.
- *Without recourse*, the buyer bears the default risk. *With recourse*, the buyer can put the loan back to the seller.

- In a *participation*, the buyer is not a party to the credit agreement, has only partial control over its terms, and is exposed to both the borrower and the seller. In an *assignment*, all rights transfer and the buyer has a direct claim on the borrower.
- A 1% share of a *pass-through* receives 1% of the pool's interest and principal, including prepayments.
- In a sequential-pay *CMO*, every class receives its coupon, but all principal goes to Class A until it is repaid, then to Class B, then to Class C.
- A *covered bond* stays on the issuer's balance sheet, backed by pledged mortgages worth more than the bonds.

3.1 Round 1: Monday (the downgraded loans)

 9:30 AM Monday

Acacia holds **A\$500m** of leveraged loans that were recently downgraded. They now trade at around 80 cents per \$1 of par.

Two bids arrive:

- a **vulture fund** offers 78 cents per \$1 of par, without recourse;
- a **regional bank** offers 84 cents per \$1 of par, but only with recourse.

(a) Are these loans distressed or nondistressed?

(b) How much cash does each bid raise?

Vulture fund = _____ (A\$m) Regional bank = _____ (A\$m)

(c) Which bid actually moves the credit risk off Acacia's books? What does the extra cash from the other bid cost Acacia?

(d) The vulture fund insists on an **assignment**. A junior banker suggests offering a **participation** instead. Give two reasons the fund prefers an assignment.

3.2 Round 2: Tuesday (securitising the mortgages)

 10:00 AM Tuesday

Acacia pools **A\$1,000m** of prime residential mortgages and sells them to a special-purpose vehicle (SPV), which issues securities backed by the pool to investors.

(a) Give two reasons Acacia uses an SPV, rather than a structured investment vehicle (SIV).

(b) First, suppose the SPV issues **pass-through** securities. In year 1 the pool pays A\$50m of interest, A\$20m of scheduled principal, and A\$30m of prepayments. An investor holds **2%** of the pool. How much does the investor receive?

Interest = _____ Principal = _____ Total = _____
(A\$m)

(c) Now suppose the SPV issues a **CMO** instead, with three classes: Class A A\$400m, Class B A\$350m, Class C A\$250m. Rates fall in year 2 and prepayments surge. Fill in each class's balance at the end of each year.

End of	Principal paid out (A\$m)	Class A	Class B	Class C
Start		400	350	250
Year 1	150			
Year 2	200			
Year 3	250			

Hint: principal goes to Class A until it is repaid, then to Class B.

(d) Which class would a bank prefer to buy, and which suits a life insurance company? Explain.

3.3 Round 3: Wednesday (a covered bond instead)

 11:00 AM Wednesday

A colleague asks: why not keep the mortgages and issue a covered bond instead? Consider a simplified part of Acacia's balance sheet:

Assets (A\$m)		Liabilities (A\$m)	
Long-term mortgages	50	Insured deposits (cost 2.0%)	25
		Uninsured deposits (cost 4.5%)	25
Total	50	Total	50

Acacia issues an **A\$25m covered bond** backed by **A\$30m of pledged mortgages**. Thanks to the excess collateral, the bond yields only **3.0%**. Acacia uses the proceeds to repay the uninsured deposits.

(a) What is Acacia's annual funding cost saving?

Saving = _____ (A\$ per year)

(b) Redraw the balance sheet after the issue.

(c) The insured deposits are now backed by how much in *unpledged* mortgages? If Acacia failed, who would bear the shortfall? How does Australia's 8% cap on covered bonds help?

(d) Compare Round 2 with Round 3. Give one advantage and one drawback of the covered bond for Acacia.

4 Part D: The big question

 Wrap-up: discuss together for the last 10 minutes

The U.S. CLO market now exceeds US\$1 trillion outstanding, comparable in scale to the 2007 subprime mortgage market. Roughly 90% of leveraged loans are covenant-lite, and CLOs buy 60–70% of new leveraged loan issuance.

Yet when COVID-19 hit in 2020, CLOs came through far better than feared, partly because the Fed's emergency facilities supported credit broadly.

Are CLOs the new subprime? What would you tell Acacia's Board before it sells more leveraged loans into CLOs?