Understanding Securitization

Here's how it works.

Securitization is a big word often heard at GM Financial, but it still produces a puzzled look on many faces. While it's not considered a direct step in the "life of a loan" process, the act of securitizing plays an essential role in financing our business. The Corporate Finance team ensures the company has access to additional capital by creating and maintaining various funding mechanisms to which recently originated loans are transferred. This additional capital is used to fund the purchase of new loans from auto dealers.

Why does the company securitize? A finance company has several funding sources available to obtain the necessary capital to run its business. These sources include deposits, bank loans, issuing corporate stock or unsecured bonds and, finally, asset-backed securities (securitizations). While GM Financial obtains capital through the issuance of unsecured bonds and utilizes bank loans, its primary source of funding is securitization. The securitization market allows GM Financial to raise large amounts of capital at costs that allow us to maximize "net interest margin" for the life of the loans.

Here's how securitization works:

1. Contracts are originated by GM Financial.

2. We then package together a pool of contracts that we originated over a period of time.
The bundled contracts are transferred to a bankruptcy-remote Special Purpose Entity (SPE), which in turn transfers the contracts to a bankruptcy-remote Asset-Backed Securities (ABS) trust.

3. The ABS trust becomes the permanent home for the contracts.

4. The ABS trust uses the loans as collateral for corporate bonds that are sold to investors.
The trust uses the proceeds from the sale of the bonds to pay the company for the loans that were transferred to the trust. Bonds backed by the expected payments on a pool of assets (such as auto loans or student loans) are known as asset-backed securities. The transaction itself is referred to as a securitization.

How do the investors get paid?

a. Each month, GM Financial's customers make payments on their auto loans.
GM Financial receives a fixed amount of money: 1) loan principal and 2) the interest portion of the customer's payment. These monthly payments are submitted directly to the ABS trust.

b. The ABS trust uses this monthly cash flow from GM Financial's customers to repay the bond investors.
The investors receive a monthly payment: 1) principal (to repay the borrowed money) and 2) interest, or coupon, which is the interest rate paid on the bonds.

c. GM Financial earns (or receives) the net interest margin – which is the difference between the interest rate that our customers pay on their auto loans and the interest rate paid to the investors.
For example, the securitization named 2007-D-F has an average customer interest rate of 16.9 percent, but we are only required to pay the investors approximately 5.5 percent. Therefore, GM Financial will earn a 11.4 percent net interest margin (16.9 percent minus 5.5 percent) on these loans before covering credit losses, operating expenses and any fees associated with the securitization.

Utilizing a securitization locks in the net interest margin for the company for the entire life of the securitization, removing exposure to changes in interest rates for these specific loans.

As net interest margin is generated, cash is available to the company to cover operating costs, credit losses and taxes. Anything left over is GM Financial's profit. This can be reinvested in new loans. Then, we start the cycle again – originating new loans, funding our dealers and transferring loans to warehouse lines or securitization trusts.

In between securitizations, the company utilizes warehouse lines of credit (bank loans) for short-term financing. This allows us to have cash on hand every day to purchase contracts from dealers and provide funding to them. The process of transferring bundled contracts to a Special Purpose Entity and then to the warehouse trust is identical to the process involved during a securitization.
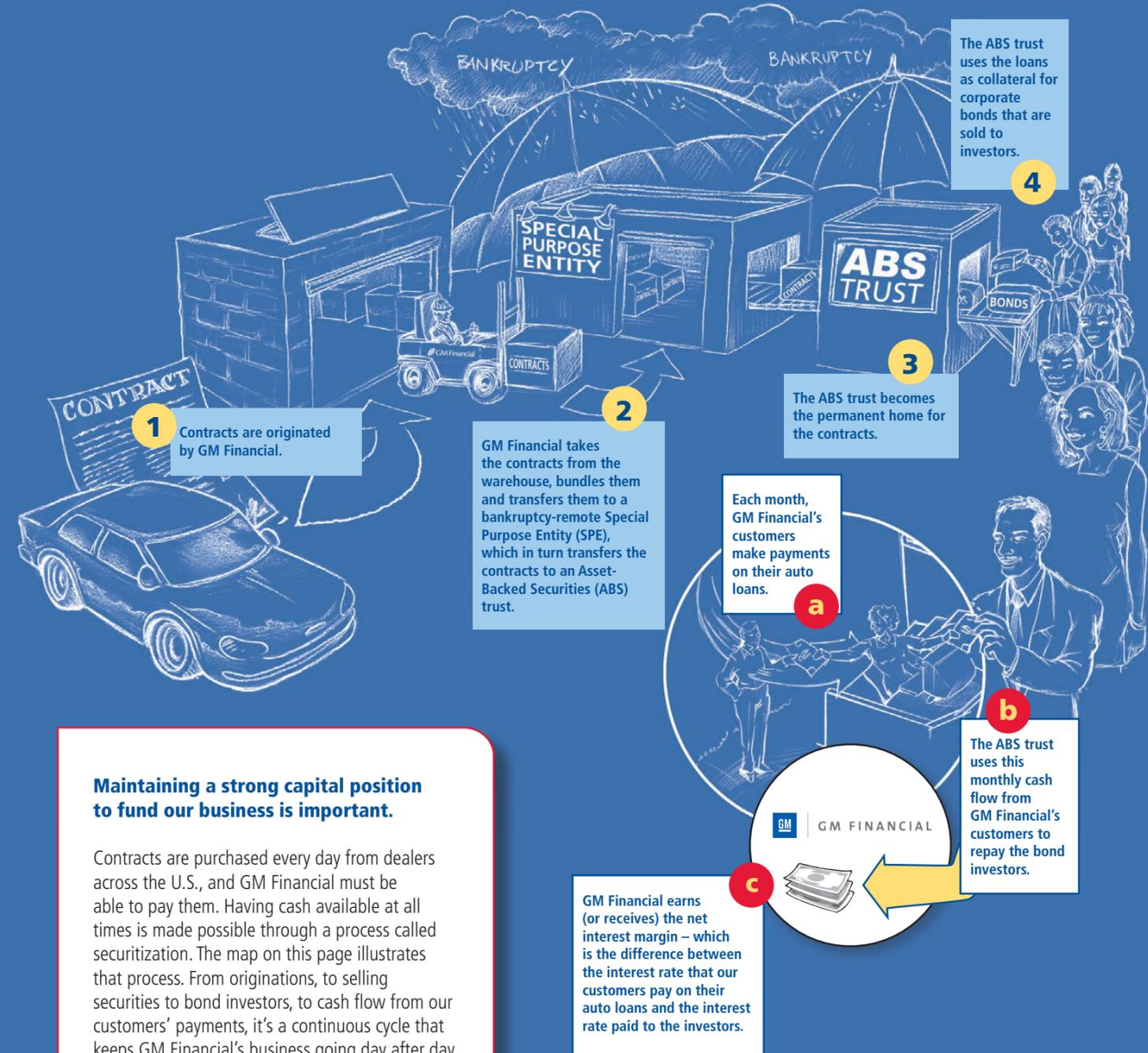
Maintaining a strong capital position to fund our business is important.

Contracts are purchased every day from dealers across the U.S., and GM Financial must be able to pay them. Having cash available at all times is made possible through a process called securitization. The map on this page illustrates that process. From originations, to selling securities to bond investors, to cash flow from our customers' payments, it's a continuous cycle that keeps GM Financial's business going day after day.

1 Contracts are originated by GM Financial.

2 GM Financial takes the contracts from the warehouse, bundles them and transfers them to a bankruptcy-remote Special Purpose Entity (SPE), which in turn transfers the contracts to an Asset-Backed Securities (ABS) trust.

3 The ABS trust becomes the permanent home for the contracts.

4 The ABS trust uses the loans as collateral for corporate bonds that are sold to investors.

a Each month, GM Financial's customers make payments on their auto loans.

b The ABS trust uses this monthly cash flow from GM Financial's customers to repay the bond investors.

c GM Financial earns (or receives) the net interest margin – which is the difference between the interest rate that our customers pay on their auto loans and the interest rate paid to the investors.