



Article

SECURITIZATION OF ASSETS

ABS AND MORTGAGE-BACKED SECURITY (MBS)



In this brief primer, we will discuss the concept of securitization and the basis for their use, as well as their impact on the economy.

The Concept of Securitization

Securitization is well established and practiced in the global debt capital market. Some sources describe it as the practice where issuers merge different financial assets into one unit, thereby creating a single financial instrument.

Securitization is a process by which a company assembles its different financial assets/debts to form a consolidated financial instrument which is issued to investors.

Similarly, it is the process of selling assets and generating cash flows from a company to another company specifically set up for that purpose. Subsequently, the receiving company issues out notes to the company from which the assets or cash flow generated was received. The cash flows from the sale of the assets back up these notes.

Securitization has also been employed as part of asset and liability management, in handling balance sheet risks. Sundareshan defines it as:

“A framework in which some illiquid assets of a corporation or a financial institution are transformed into a package of securities backed by these assets, through careful packaging, credit enhancements, liquidity enhancements and structuring.”

The practice of securitization allows institutions like Corporates and Financial Institutions to modify the assets that cannot be readily marketable to rated securities tradeable in the secondary markets. Residential mortgages and car loans are a typical example of these types of assets. This allows investors to gain access to these types of original assets which would not have otherwise been accessible. This merger and packaging process creates asset-backed bonds, which are debt instruments created from a smorgasbord of loan assets from which interest is payable on a floating basis.

Essence Of Securitization?

The fundamental reason behind securitization is the need for institutions to derive value from the assets on their balance sheet. These assets could be residential mortgages, corporate loans, debt instruments, among others.

Some of the factors that necessitate securitization include:

- a. Where size of assets is decreasing and revenues are not realised from them, it could lead to an increase in the return on equity ratio.
- b. The capital expended in managing balance sheets would reduce, which will aid costs savings and allow the

- c. The interest payable on Asset-backed securities is usually lesser than other underlying loans, therefore creating surplus cash for the original entity.

Summarily, banks securitize for three reasons; funding its own assets, managing its balance sheet, and risk management.

The benefits of securitization to investors in the ABS market is considerably high. Through ABS, investors can diversify their risk and sectors of interest, they can access an array of risk-reward profiles and importantly, access markets that are otherwise closed off for them. Securitised notes habitually offer a better risk-reward performance than corporate bonds of the same maturity and therefore offer assurance to investors.

The Securitization Process

The securitization exercise involves different components. There is the original company or institution (the originator) whose assets are being securitized. The process involves an issuer buying off these assets from the originator. This issuer is usually an SPV created specifically for that purpose and is usually domiciled off shore. The purpose of the SPV is to ensure that these assets are held separate from the other assets of the originator. So for instance, where the originator is declared bankrupt or is facing a liability claim, the assets in the SPV would not be affected. This is called being ‘bankruptcy-remote’. On the other hand, if the assets in the SPV do not yield, investors cannot claim against the originator. Where these assets are held in an SPV structure, the financial ratings of the originator become totally irrelevant to the bond-holder.

The process also involves credit enhancements, where a third party guarantees the credit quality of the SPV, therefore giving the issued notes strong investment grade ratings. The SPV is structured in a way that the issued notes carry lower costs than the assets of the SPV. This allows the originator to secure lower-cost funding otherwise unavailable in the unsecured markets. This is particularly more beneficial for institutions with a low credit rating.

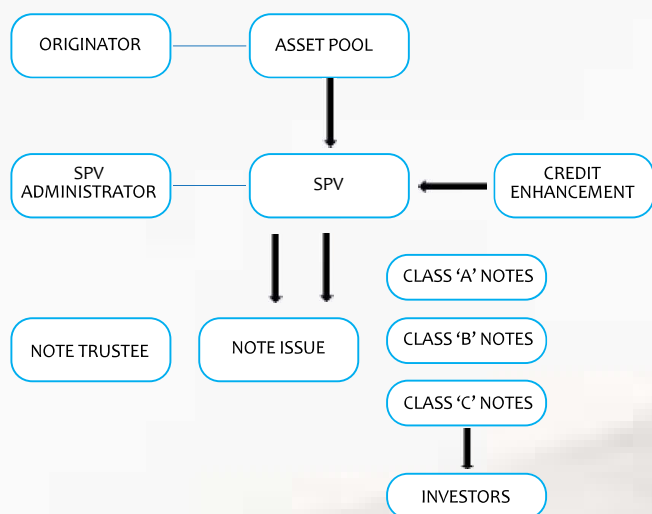


Figure 1: The process of securitization.

Mechanics of Securitization

Securitization reflects a true sale of the assets of an originator on its balance sheet. This is why the SPV, being a separate legal entity is required to play the role of note issuers. The securitised assets are sold into the SPV's balance sheet, and therefore divorced from that of the originator. The process involves:

- Due diligence on the prospects of the assets
- Setting up an SPV and transferring of assets to it
- Underwriting of loans for credit quality and servicing
- Determining the nature and structure of the note; is it going to be issued in series or at once
- Rating of the notes by one or more credit rating agencies
- Placing the notes on the capital market.

In order for the transfer of the assets to the SPV to be legally recognised, the assets must be 'sold' to the SPV. Another major consideration for an originator is the choice of its underwriting bank, who will have to structure the deals and place the notes.

SPV Structures

There are usually three types of securitization structures being employed; amortising, revolving and the master trust.

Amortising Structures

The Amortizing Structure, which simply means periodical pays off of principal and interest, pays the principal and interest to investors on a coupon-by-coupon basis throughout the lifespan of the security. Their pricing is subject to their expected maturity. This is also called the pass-through structure, and are more commonly used in residential and commercial mortgage backed deals.

Revolving Structures

The Revolving Structure is designed in a way that allows for the principal of the assets to be revolved. The collections on the principal are used to purchase new receivables that fulfil the necessary criteria. This structure is usually used for short term assets having high pre-payment speed, such as credit card debts and car loans. Principal payments are paid to investors either in a series of instalments in equal value or as a lump sum at the maturity of the notes.

Master Trust

Master trusts are more frequently used in the United States and the UK. It allows a single SPV to issue multiple securitizations. The originator transfers the assets to the master SPV, where then notes are issued out of the asset pool based on the investor's demand. It is mostly used by mortgaged based securities and credit card ABS originators.

Credit Enhancement

The credit strength of the SPV and the backed assets are vital in influencing investor decisions. Credit enhancement are measures initiated so that the issue notes acquire the necessary credit status to woo in investors. It can be done through the following means:

- **Over-collateralisation:** - where the value of the asset is more than the value of the issued notes.
- **Pool Insurance:** - an insurance policy from a reputable insurance firm to cover the risks around the pool.
- **Classification of Notes:** - notes can be classed into junior and senior classes where the notes of a junior class owner is subordinated to the rights of a senior owner.
- **Margin Step – up:** - a number of issuers include a step-up feature in the coupons, which served as incentives for investors.
- **Excess Spread:** - excess spread is usually the difference between the interest payable on a note and the return on the underlying assets. These are periodically used to cover expenses and losses.

Whichever structure is used; the cash waterfall process remains the preferred return model. All cash generated by the asset pool is paid in order with pre-arranged payment priority. Senior obligations are met before the junior ones. An independent valuation expert is usually retained to value the asset and determine whether it can service all the vehicle's obligations.

Impact on Balance Sheet

Securitization has an effect on the liability side of an originator's balance sheet. From the process, some identified assets have been removed from the balance sheet, although the originator retains the first-loss piece.



The first-loss amount is then deducted from the originator's capital position. For example, let's imagine a bank has N100 million worth of assets that have been risk-weighted, with a target Basel ratio of 12% (under Basel III, the minimum capital ratio a bank must maintain in 8%, but they prefer to set aside an amount in excess), and it goes on to securitize the entire N100 million worth of assets. It retains the first-loss series which is 1.5% of the total issue. The other 98.5% is then sold in the market. The bank still has 1.5% of the capital reserved against possible future losses, but is now free of the remaining 10.5% of the capital.

Conclusion

Securitisation occurs where some assets of a company are lifted from its balance sheet and are funded by third party investors. The investors in return, receives financial instruments evidencing the investment and doing away with a lending institution. As derivatives of the conventional secured debt instruments, structured financing instruments are supported by a lien on selected assets or by a credit enhancement scheme such as a guarantee. In traditional secured bonds, the primary source of repayment of the bond remains the liquidity and cash flow of the issuer. With securitised transactions, that burden of repayment on the bonds shift from the issuer to a pool of assets which have been securitised.

Authors



Ibrahim Usman Wali

Member, Capital Market Team, Omaplex Law Firm
Ibrahim.wali@omplex.com.ng