

## **A CRITICAL REVIEW OF ASSET SECURITIZATION**

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### **1. INTRODUCTION**

#### **1.1 Definition of Asset Securitization**

Securitization is the process of transforming a non-security asset into a security. Usually the term is used to describe the transformation of a pool of loans into bonds. Most economists and market participants also include the sale or issue of the bonds in the securitization process. “Securitization” is defined as i) pooling loans and ii) issuing bonds backed by those loans. The issuer retains no credit risk on sold bonds, so a default on an asset backing a sold bond affects the payments received by the bondholder but has no direct financial effect on the issuer. The asset is completely removed from the issuer’s balance sheet.

#### **1.2 Economic and other effects of Asset Securitization**

The economies of different countries have been affected with different degrees of intensity according to their exposure to some of the main drivers of the financial crisis (Acharya and Richardson, 2009). Securitization, which has been largely blamed as one of the main contributors to the financial meltdown, is an important example in place.

It is highly likely that by augmenting the amount of funding available to banks, securitization activity had a significant and positive impact on credit growth during the years prior to the crisis (Loutskina and Strahan, 2009, Altunbas et al., 2010). In a number of countries experiencing a period credit growth, securitization activity probably strengthened the feedback effect between increases in housing prices and the credit expansion. The growth in securitization issuance also led to laxer credit standards and looser screening of borrowers thereby supporting higher credit growth in the years prior to the crisis (Keys, Mukherjee, Seru

and Vig, 2010). This is because securitization involves a longer informational distance than ordinary loans between the loan's originator and the ultimate bearer of the loan's default risk.

Overall, the rapid development in the market for credit risk transfer played a major role in altering banks' functions.

Structurally, securitization allowed banks to turn traditionally illiquid claims (overwhelmingly in the form of bank loans) into marketable securities. The development of securitization has therefore allowed banks to off-load part of their credit exposure to other investors thereby lowering regulatory pressures on capital requirements allowing them to raise new funds. The broad idea is that the availability of credit risk transfer mechanisms has changed banks' role dramatically from their traditional relationship based lending to originators and distributors of loans. This change has implications on bank's incentives to take on new risks (Shin, 2009).

However, the overall view prior to the recent credit crisis was that in addition to allowing lenders to conserve costly capital, securitization improved financial stability by smoothing out the risks among many investors (Duffie, 2008). Indeed, a widely held view prior to the recent global credit crisis, underlined the positive effect of securitization in diversifying credit risk across the financial system, strengthening its overall resilience (Greenspan, 2005). Jiangli and Pritsker (2008) argue that securitization increased bank profitability and leverage while reducing overall insolvency risk. Other studies also found a positive effect of securitization on bank performance.

## **2. PLAYERS INVOLVED IN SECURITIZATION**

In particular, banks more active in the securitization market were found to have lower solvency risk and higher profitability levels (Duffee and Zhou, 2001; Cebenoyan and Strahan, 2004; Jiangli et al., 2007).

### **2.1 Originators**

Originators create the assets that are sold or used as collateral for asset-backed securities. Originators include finance companies, financial institutions, commercial banks, and insurance companies, thrift institutions and securities firms.

### **2.2 Servicer's**

They are usually the originators or affiliates of the originators of the assets, are responsible for collecting principal and interest payments on the assets when due and for pursuing the collection of delinquent accounts. They also provide the trustee and the certificate holders with monthly and annual reports about the portfolio of assets sold or used as collateral.

### **2.3 Issuers**

The originator does not usually sell assets to third-party investors directly as asset-backed securities. Instead, they are sold first to either a conduit or a “bankruptcy – remote” finance company. Such companies, known as limited purpose corporations, are subsidiaries or affiliates of the originator or the merchant banker that were separately incorporated to facilitate the sale of assets or to issue collateralized debt instruments. Conduits are issuers of asset-backed securities that do not originate or necessarily service the assets that underlie the securities. They buy assets from different originators or sellers, pool the assets and then sell them to investors.

### **2.4 Merchant Bankers**

As asset-backed securities issue involves a merchant banker, who either underwrites the securities for public offering or privately places them. As an underwriter, the merchant banker purchases the securities from the issuer for resale. In a private placement, the merchant banker does not purchase the securities and resell them, rather the merchant banker acts as an agent for the issuer, matching the seller with a handful of buyers.

### **2.5 Credit Enhancers**

Credit enhancement is a vehicle that reduces the overall credit risk of a security issue. The purpose of the credit enhancement is to improve the rating, and therefore the pricing and marketability of an asset-backed security. Most ABS are credit enhanced. Credit enhancement can be provided by the issuer or by a third party. The issuer has enhanced credit by providing recourse through senior- subordinated structure or by over-collateralization.

### **2.6 Rating agencies**

Credit rating agencies assigns rating to ABS issues just as they do for corporate bonds. Credit rating is based on three criteria: the probability of the issuer defaulting on the obligation, the nature and provisions of the obligation and the relative position of the obligation in the event of bankruptcy.

### **2.7 Trustees**

A Trustee in ABS is the intermediary between the servicer and the investors and between the credit enhancer and the investors. The responsibilities of the trustee include buying the assets from the issuer on behalf of the trust and issuing certificates to the investors.

As the obligors make principal and interest payments on the assets, the servicer deposits the proceeds in a trust account, and the trustee passes them on to the investors.

### **3. PROCESS OF SECURITIZATION:**

#### **3.1 introduction**

According to John Henderson & Jonathon Scott (1989), it is a process which takes place when a lending institution's assets are removed in one way or the other from its balance sheet and are funded instead by the investors who purchase a negotiable financial instrument evidencing this indebtedness, without recourse to the original lender. The process of securitization primarily involves three parties namely, the originator, the special purpose vehicle (SPV) and the investor. The originator is the one who owns the financial asset and who wants to offload the same in the market. The originator could be a banking, industrial or finance company. The SPV or in other words the issuer is the one who issues mortgage-backed securities to investor in the market. Generally merchant bankers function as SPV's.

#### **3.2 Asset Identification:**

The 'originator', first identifies the asset or a pool of assets that have to be securitized. There must be some basic conditions that must be satisfied by an asset, which is to be securitized. For instance, the cash flows from the reference asset should be reliable and payments should be periodically obtained. This means that the asset portfolio should have a documented history showing default and delinquency experience. The assets have to be of good quality that in turn facilitates the marketability to be quick and easy. This is to ensure that default risks are brought down considerably. The pool of assets should carry identical dates of interest payment and maturities. Assets that stand a chance of being sold to investors ideally should have the features like: a) be well diversified; b) Have a statistical history of loss experience; c) be homogenous in nature; d) be broadly similar in repayment and final maturity structures; e) be to some extent liquid.

#### **3.3 Structuring the Asset Backed Securities**

In a typical securitization deal, the asset originator creates a SPV and sells reference assets to the same. The SPV can either be a trust, corporation or form of partnership set up specifically

to purchase the originator's assets and act as a conduit for the payment flows. Payments advanced by the originators are forwarded to investors according to the terms of the specific securities. The SPV then structures the ABS based on the preferences of the originator and the investors. To make the ABS attractive to the investors, issuers follow some credit enhancement procedures.

Credit enhancement in securitization is a way of increasing the credit quality of the security above the original loan pool to increase the likelihood of buyers receiving payment. After structuring the ABS, they are offered to the investor public through a merchant banker. The issuer takes up the responsibility of creating a market in the securities that are created.

### **3.4 Investor Servicing**

The investor is serviced by periodic payments depending on the nature of the ABS. According to the terms of the issue, the investor may be paid interest periodically and the principal at the end of the maturity as a bullet payment. Or they may be paid both interest and principal periodically over the period of maturity. Investors buy this risk if they see the risk as a diversifying asset, the risk premium demanded by them for underwriting such a risk is lower than the internal funding costs of the originator who has a concentration of such a risk.

## **4. TYPES, BENEFITS AND STRUCTURE OF ASSET SECURITIZATION**

### **4.1 Mortgage Backed Securities**

These are securities wherein mortgages are pooled together and undivided interests or participations in the pool are sold. The mortgage backing, a pass through security is generally of the same loan type in terms of amortization level, payment, adjustable rate etc. The originator services the mortgages collecting the payments and passing through the principal and interest to the security holders after deducting the servicing, guarantee and other fees.

### **4.2 Asset Backed Securities**

These are securities backed by financial assets. These assets generally are receivables other than mortgage loans and may consist of credit card receivables, auto loans, manufactured housing contracts, junk bonds, equipment leases, small business loans guaranteed by some agency home equity loans etc. They differ from other kind of securities offered in the sense that their creditworthiness is derived from sources other than the paying ability of the originator of the

The evolution of securitization is not surprising given the benefits that it offers to each of the major parties in the transaction.

### **4.3 Benefits of Asset Securitization**

#### **4.3.1 Originators**

For originators securitization improves returns on capital by converting an on-balance-sheet lending business into an off-balance-sheet fee income stream that is less capital intensive. Depending on the type of structure used, securitization may also lower borrowing costs, release additional capital for expansion or reinvestment purposes, and improve asset/liability and credit risk management.

#### **4.3.2 Investors**

For Investors securitized assets offer a combination of attractive yields (compared with other instruments of similar quality), increasing secondary market liquidity, and generally more protection by way of collateral overages and/or guarantees by entities with high and stable credit ratings. They also offer a measure of flexibility because their payment streams can be structured to meet investors' particular requirements.

#### **4.3.3 Borrowers**

For borrowers benefit from the increasing availability of credit on terms that lenders may not have provided had they kept the loans on their balance sheets. For example, because a market exists for mortgage-backed securities, lenders can now extend fixed rate debt, which many consumers prefer over variable rate debt, without overexposing themselves to interest rate risk. Credit card lenders can originate very large loan pools for a diverse customer base at lower rates than if they had to fund the loans on their balance sheet.

#### **4.3.4 Providing Credit enhancement in the Economy**

Securitization typically splits the credit risk into several tranches, placing it with parties that are willing or best able to absorb it.

The first loss tranche is usually capped at levels approximate to the "expected" or "normal" rate of portfolio credit loss. All credit losses up to this point are effectively absorbed by the credit originator, since it typically receives portfolio cash flow after expenses (which include expected losses) in the form of excess spread.

The second tranche typically covers losses that exceed the originator's cap. This second level of exposure is usually capped at some multiple of the pool's expected losses (customarily between three times and five times these losses), depending on the desired credit ratings for the senior positions. This risk is often absorbed by a high-grade, well-capitalized credit enhancer that is able to diversify the risk.

The third tranche of credit risk is undertaken by the investors that buy the asset-backed securities themselves. Although investors are exposed to other types of risk, such as prepayment or interest rate risk, senior-level classes of asset-backed securities typically have little exposure to credit loss.

#### **4.3.5 Cash Flow Allocations**

The payment distribution for securities backed by installment loans is closely tied to the loans' payment flows. Interest is customarily paid monthly, and the principal included in each payment will depend on the amortization schedule and prepayment rate of the underlying collateral.

For revolving asset types such as credit cards, trade receivables, and home equity lines, the cash flow has two phases: the Revolving period and Early Amortization Protection

During the revolving period, investors receive their pro rata share of the gross portfolio yield based on the principal amount of their certificates and the coupon rate. The remaining portion of their share of the finance charges above the coupon rate is available to pay the servicing fees and to cover any charge-offs, with residual amounts generally retained by the seller or credit enhancement provider as excess spread. This distribution of cash is often referred to as the "cash flow waterfall." In addition to the previously discussed credit enhancement types, revolving asset-backed securities typically use early amortization triggers to protect investors from credit risk. These triggers, or payout events, accelerate the repayment of investor principal if cash flow from the pool declines or the condition of the pooled assets deteriorates. This accelerated repayment method requires that the investors' share of all principal collections be returned immediately as it is received by the trust.

#### **4.4 Structuring The Transactions**

The primary difference between whole loan sales or participations and securitized credit pools is the structuring process. Before most loan pools can be converted into securities, they must

be structured to modify the nature of the risks and returns to the final investors. Structuring includes the isolation and distribution of credit risk, usually through credit enhancement techniques, and the use of trusts and special purpose entities to address tax issues and the management of cash flows.

#### **4.4.1 Segregating the Assets**

Securitization allows investors to evaluate the quality of a security on its own (apart from the credit quality of the originator/seller). To accomplish this, the seller conveys receivables to a trust for the benefit of certificate holders. For revolving-type assets, this conveyance includes the amount of receivables in certain designated accounts on a specific cutoff date, plus the option for the trust to purchase any new receivables that arise from those designated accounts subsequent to the cutoff date. The accounts and receivables are subject to eligibility criteria and specific representations and warranties of the seller.

#### **4.4.2 Creating Securitization Vehicles**

Banks usually structure asset-backed securities using “grantor trusts,” “owner trusts,” or other “revolving asset trusts,” each of which customarily issues different types of securities. In choosing a trust structure, banks seek to ensure that the transaction insulates the assets from the reach of the issuer’s creditors and that the issuer, securitization vehicle, and investors receive favorable tax treatment.

### **5. RISKS AND CONTROLS**

#### **5.1 introduction**

Some risks could be due legal and tax issues. When banks are sellers of assets, they have two primary legal concerns. They seek to ensure that: a security interest in the assets securitized is perfected and the security is structured so as to preclude the FDIC’s voiding of the perfected security interest.

By perfecting security interests, a lender protects the trustee’s property rights from third parties who may have retained rights that impair the timely payment of debt service on the securities.

Issuers ordinarily choose a structure that will minimize the impact of taxes on the security. National income tax can be minimized in two principal ways — by choosing a vehicle that is



not subject to tax or by having the vehicle issue “debt” the interest on which is tax deductible (for the vehicle or its owners).

Although it is common for securitization transactions to receive substantial attention early in their lives, the level of scrutiny generally declines over time. Many of the problems that institutions have experienced, such as rising delinquencies and charge-offs, inaccurate investor reporting, and bad publicity, have occurred in the later stages of the transaction. The bank should supervise and monitor a transaction for the duration of the institution’s involvement.

### **5.1.1 Reputation Risk**

Reputation risk is the risk to earnings or capital arising from negative public opinion. This affects the institution’s ability to establish new relationships or services or continue servicing existing relationships. This risk can expose the institution to litigation, financial loss, or damage to its reputation. Reputation risk is present throughout the organization and includes the responsibility to exercise an abundance of caution in dealing with its customers and community.

### **5.1.2 Strategic Risk**

Strategic risk is the risk to earnings and capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of an organization’s strategic goals, the business strategies developed to achieve those goals, the resources deployed against those goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities.

### **5.1.3 Credit Risk**

Credit risk is the risk to earnings or capital arising from an obligor’s failure to meet the terms of any contract with the bank or otherwise to perform as agreed. Credit risk is found in all activities where success depends upon counterparty, issuer, or borrower performance. It arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether on or off the balance sheet.

#### **5.1.4 Transaction Risk**

Transaction risk is the risk to earnings or capital arising from problems with service or product delivery. This risk is a function of internal controls, information systems, employee integrity, and operating processes. Transaction risk exists in all products and services.

#### **5.1.5 Liquidity Risk**

Liquidity risk is the risk to earnings or capital arising from a bank's inability to meet its obligations when they come due, without incurring unacceptable losses. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources. Liquidity risk also arises from the bank's failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

#### **5.1.6 Compliance Risk**

Compliance risk is the risk to earnings or capital arising from violations or nonconformance with laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of the bank's clients may be ambiguous or untested. Compliance risk also exposes the institution to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, reduced franchise value, limited business opportunities, lessened expansion potential, and lack of contract enforceability.

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