

Benefits of Securitisation An Issuer's Perspective

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What is securitization?

Securitization is pooling of “homogeneous,” “financial,” “cash flow producing,” “illiquid” assets and issuing claims on those assets in the forms of marketable securities. Using securitization, financial institutions and industrial firms can make certain assets suitable for sale in the capital market. The higher yield associated with these securities attracts investors who are willing to bear incremental credit, prepayment and liquidity risk.

Figure : **PARADIGM SECURITIZATION STRUCTURE**

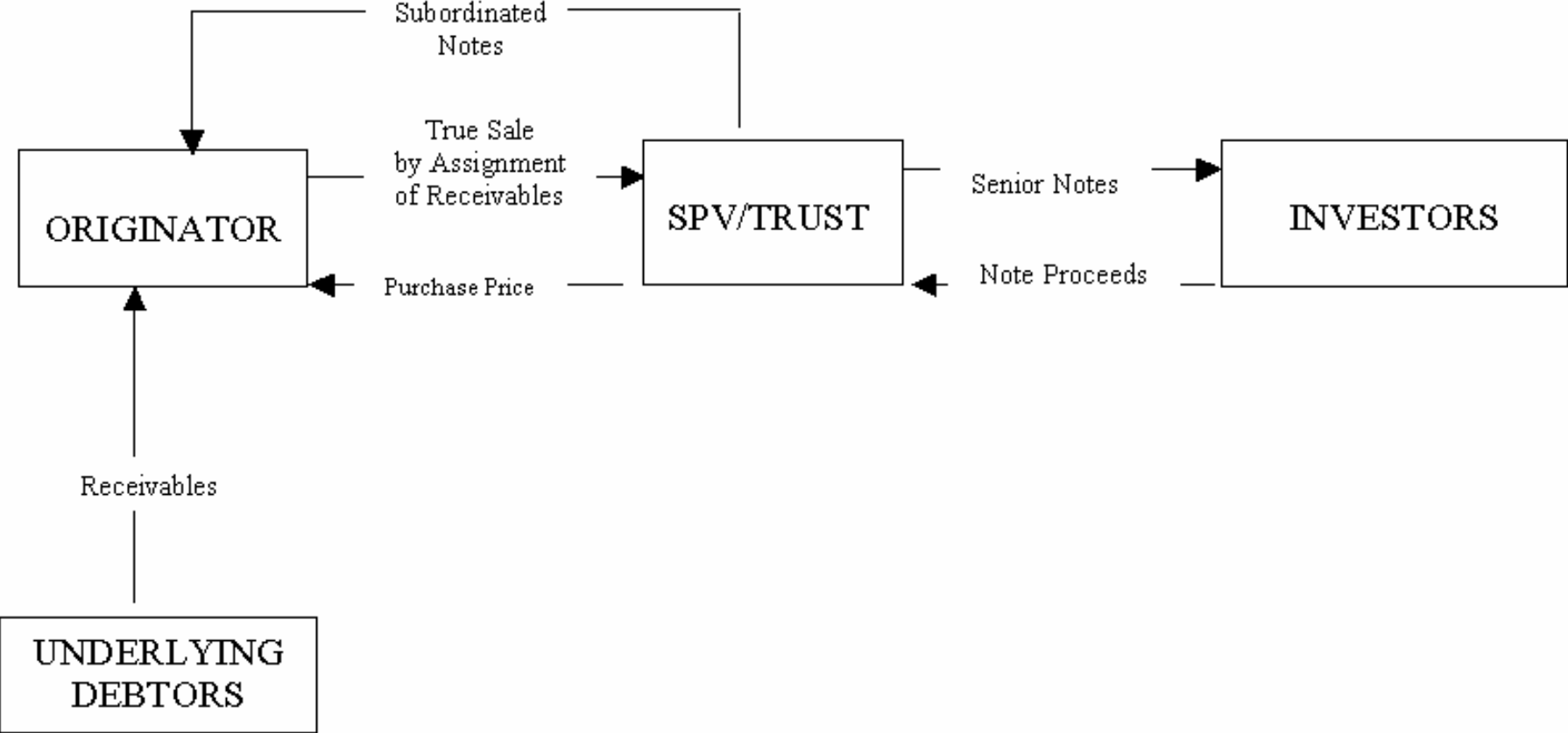
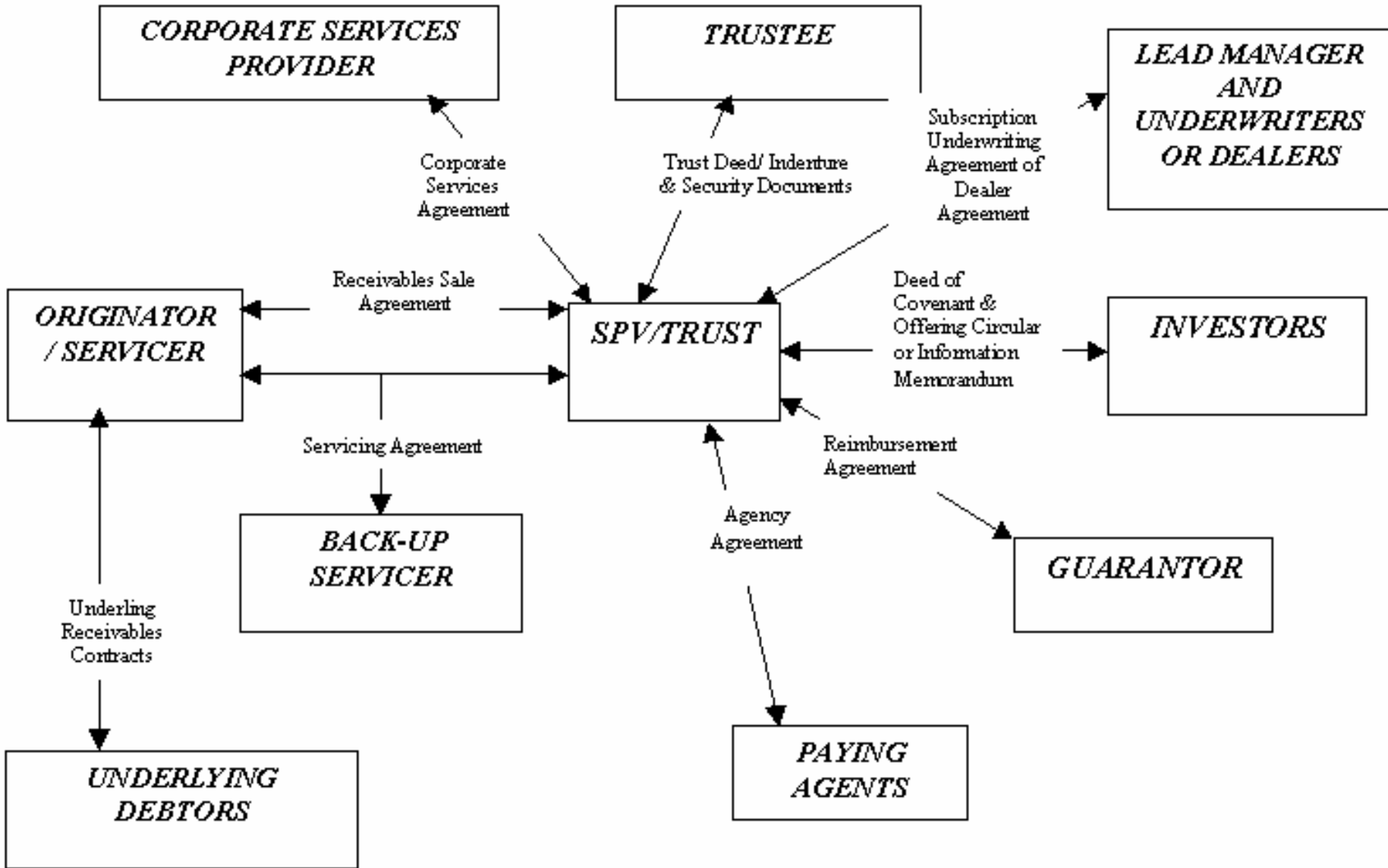


Figure : **MAIN PARTIES AND DOCUMENTATION STRUCTURE**



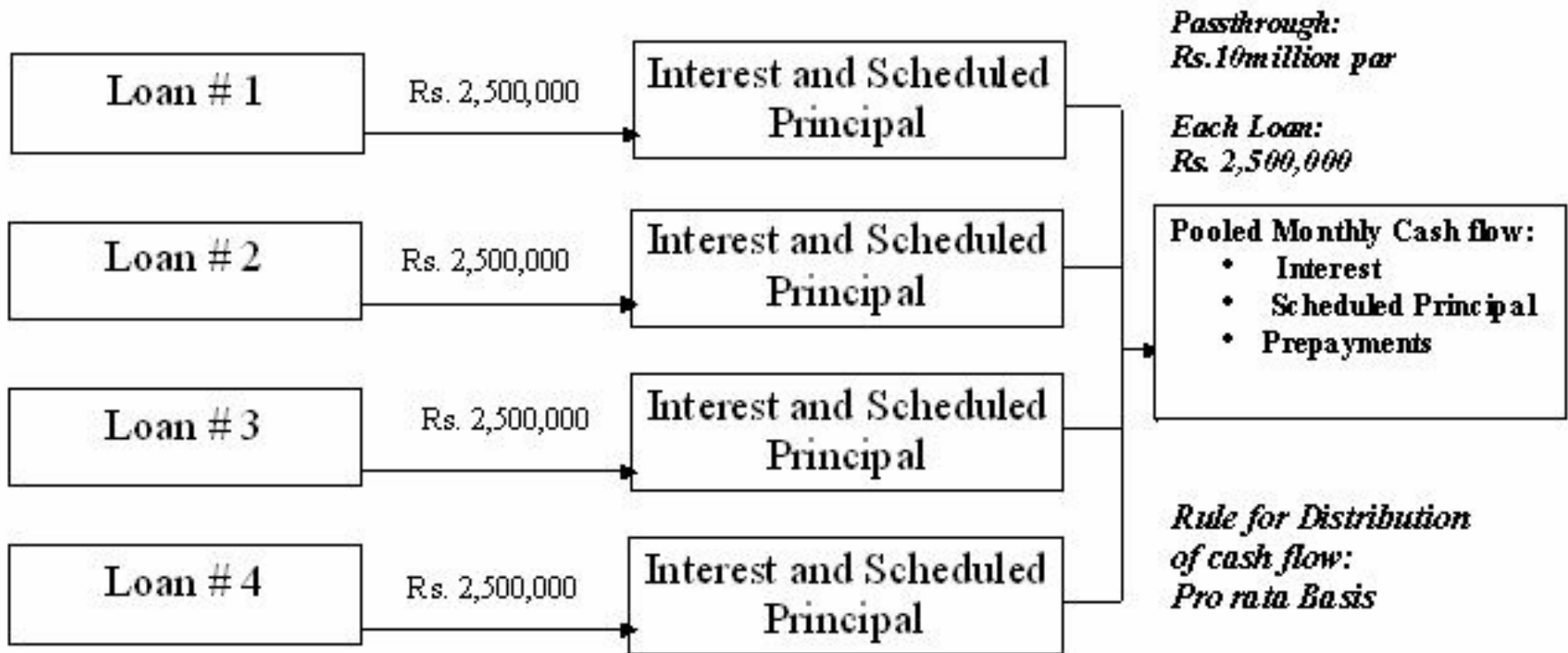
Features and Benefits of Pass-Through Securities

General Description

- Basic mortgage security
- Mortgage-backed securities involve
 - Pooling loans of one or more mortgage originators to form the underlying assets for the security
 - Selling shares in the pool to investors to create pass-through security
- Stream of cash flows received from the collateral is passed on to investors in an undivided manner
 - Investors receive percentage of available funds on a monthly basis
 - Payment based upon the percentage of ownership of the pool balance
- Represents a true sale of assets for the issuer- -considered off-balance sheet financing

Features and Benefits of Pass-Through Securities

General Description



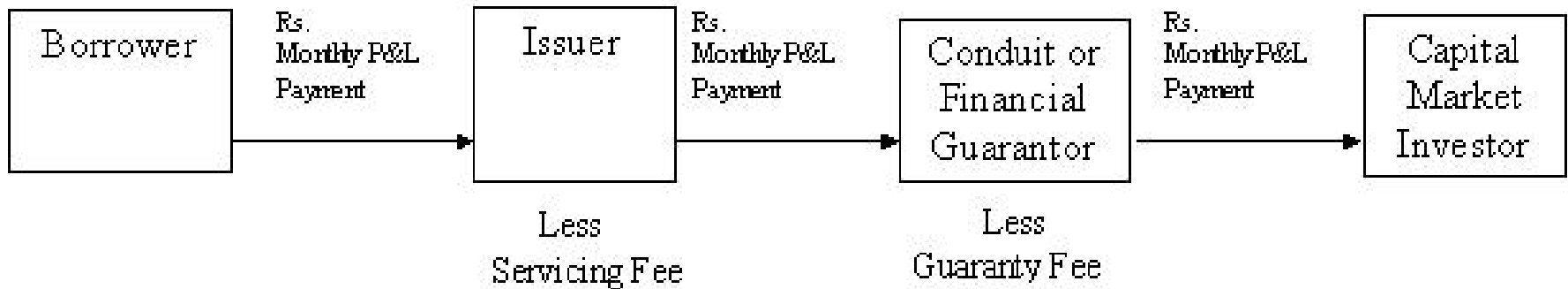
Each Loan is Rs. 2,500,000
Total Pool Amount: Rs 10 Million

Features and Benefits of Pass-Through Securities

Cash Flow Characteristic

- Cash flows generated by mortgage pool are passed on to the investor net the servicing spread

Pass – Through Coupon = Gross Mortgage Coupon – Servicing Spread
Servicing Spread = Servicing Fee + Guarantee Fee



Cash flows includes:

- Scheduled interest
- Scheduled Principal repayments
- Unscheduled payments
(Including partial prepayments and prepayments of the entire outstanding balance of the loan)

Gross Mortgage Coupon (Note Rate)	= 11.00%
Servicing Fee to Issuer (Servicer)	= (.25%)
Mortgage Coupon to Conduit	= 10.75%
Guarantee Fee(Conduit)	= (.25%)
Pass-Through Coupon to Investor	= 10.50%

Features and Benefits of Pass-Through Securities

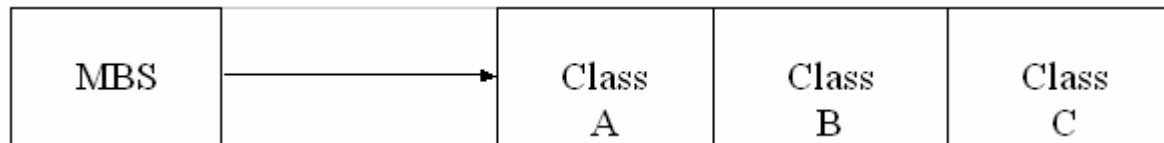
Cash Flow Characteristic

- Servicing Fee provides compensation to the issuer (or servicer) for assuming loan administration responsibilities including:
 - Record maintenance and custody
 - Cash management and accounting
 - Collections and delinquency management
 - Investor reporting (as required)

Features and Benefits of Structured Securities

General Description

- Multi-class bond issue that derives cash flows from underlying mortgages—either pass-through securities (MBS) or pools of whole loans.



- Cash flows are carved up and distributed based upon principal and interest payment rules to various tranches of the transaction structure.
- Financially engineered to meet specific needs of various investors by re-directing cash flows to minimize certain risks:
 - Prepayment risk redistributed in to series of classes with short -, intermediate- and long – maturities.
 - Some classes have less interest rate sensitivity but lower yield to investors
 - Other classes have substantially greater class for variability but offer investors higher returns.

Feature and benefits of Structured Securities Issuer Perspective

- Structures securities are more costly and time consuming for the originator of the loans—compared to pass-through securities
 - Must pay an investment bank for the structuring and placement of the deal with investors
 - Must pay to have the deal rated by a rating agency
 - Subject to the market to determine if the deal will sell above or below par
- Complexity of the cash flow distribution must be administered each month to ensure that investors are accurately paid—process must either be managed by the issuer or outsourced to a service provider at additional cost.
- Often unable to sell the subordinated Ted, highest risk tranche, so the originator must keep it on their own sheet.

Analysis of Structured Security Classes

Advantages to Structured Securities

- Offer the possibility of satisfying more investors' demands with respect to cash flow variability over pass through-securities and stripped mortgage-backed securities:

- Structured securities provide:
 - Same credit quality and yield advantage of standard MBS
 - Varying coupon rates
 - Monthly ,quarterly, semi-annual and annual payment schedules
 - Range of maturities with a modified form of call protection
 - Alternative prepayment sensitivities

Features and Benefits of Pass-Through Securities

MBS versus MBB

Characteristics	Mortgage Backed Bond	Mortgage-Backed Security
Balance Sheet Treatment	On-balance sheet treatment	Off-balance sheet treatment
Source of Payment	Issuer's cashflow	Collateral cashflow
Collateral	Secured by pool of mortgages that are substitutable	Secured by pool of Mortgage that are not substitutable
Pool Structure	Typical heterogeneous	Typically homogenous
Rating	Dependent on rating of the issuer and mortgage assets	Dependent on quality of mortgage and/ or guarantor
Cash flow Schedule	Interest typically payable on annual basis—principal repaid at maturity	Principal and interest payable on a monthly basis

Deeds of Assignment	– Originator and Trustee
Trust Deed	– Originator and Trustee
Collection and payout account Agreement	– Originator and Trustee
Cash Collateral Agreement	– Originator and Trustee
Agreement with Investment banker	– Manager and Originator

Why Securitized? Issuer's perspective

Securitization offers several benefits to an issuer. Instead of simply listing out the benefits, let's take a methodical approach to finding out the pros and cons of a securitization. For the purposes of this illustration, we will assume the following balance sheet for company XYZ, which has "A" rated long-term unsecured debt.

Company XYZ
Balance Sheet (amounts in millions)
As of 12/31/XX

Assets

Cash	100
Investment in mortgages	500
Other	400

Liabilities

Deposits	300
Senior notes due 2008 (Unsecured "A" rated debt)	500

Equity

Share Capital	200
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Need cash?

If Company to issue new ten – years secured debt company's balance sheet will show more assets and more liabilities as follows:

Company XYZ
Balance Sheet (amounts in millions)
As of 12/31/XX

Assets

Cash	500
Investment in mortgages*	500
Other	400

Liabilities

Deposits	300
Senior notes due 2008	500
Senior secured notes due 2008*	400

Equity

Share Capital	200
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A point to note is that the debt - to – equity ratio would also increase from 4.0 to 6.0 indicating a more leveraged company, which may not be very well accepted by the existing creditors and the rating agencies.

- Off- balance sheet funding.

If the company sell its existing assets via securitization, the desired alternative in most securitization transactions is to structure the transaction that will result in “off- balance sheet” treatment for the existing assets. If the securitization is a sale, cash and proceeds are added to the assets and the transferred or sold assets are taken off balance sheet. Of course, certain conditions have to met in order to get the off – balance sheet treatment. Here the debt to equity remains at 4.0 indicating a satisfactory leveraged positions.

Company XYZ
Balance Sheet (amounts in millions)
As of 12/31/XX

Assets

Cash	590
Investment in securities	10
Other	400

Liabilities

Deposits	300
Senior notes due 2008	500

Equity

Share Capital	200
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- Improved rating.

One of the conditions of a properly structured securitization is the isolation of assets from the creditors of the company. Separation of good credit quality assets from a company's core risky business will likely result in an enhanced rating for the securities backed by those assets alone; a rating better than that of its owner at the time. The improvement comes from two sources: one, the new securities are supported by the cash flows from isolated assets without any intervention from the issuing Company itself which means that the ratings of the securities will not be hampered by any extrinsic factors related to the Company and will be solely depended on the quality of the sold assets and, two, this transfer is generally a legal true sale by the company to the special purpose vehicle or Trustee potentially disabling any stay orders on the cash flows from the assets to the investors.

- Lower all - in- cost.

In the capital markets, higher rated debt commands lower cost associated with issuing such debt. A point to note is that as issuers' ratings improve the advantages of securitization diminish because such issuers can have access to cheaper funding via other means.

An issuer can attract investors willing to lend at lower rates for highly rated securities which are backed by the cash flows from the separated assets; even those investors who would otherwise not lend money to such issuers. The income on assets and return of principal of those assets can be passed through to the investors making the process "self – financing," which means there is no reliance on the income of the company to meet the debt service. Securitization can create a variety of instruments ranging from short term securities to long term securities, low coupon or high coupon, positive and negative duration, different pre payment risk, etc, which is appealing to many new investors.

The term of risk based capital stems from the regulatory requirements of capital reserves **pari passu** with the credit risk of the assets a financial institution is holding. Assets are classified in to various risk categories and a risk weight is assigned to each asset in each categories. Generally, loans carry a higher risk weighting – for example commercial loans are 100 % risk – weighted and residential loans are on the 50 % risk – weighted. Institutions that hold risky assets on their balance sheet have a higher capital reserve requirement.

If a bank were holding “A” rated loans worth \$ 4 billion, the required pre securitized capital would be 8 % (100 % risk – weighted) or \$ 320 million. If such bank securitizes 97 % of its portfolio and holds 3 % of the unrated first loss security as credit enhancement for the securitization, the required new capital is 100 % of the loan portfolio not securitized or \$120 million. This amounts to a freed up capital of \$ 200 million. This cost results from restricting the entity from leveraging its equity. By isolating the “securitizable” assets and removing such assets from an institution’s balance sheet, one can further lower the “effective” cost of financing. This newly released capital can be deployed for other purposes.

If Company XYZ had a “AAA” rated unsecured debt, this process will be rendered useless because it might be cheaper for the Company to raise additional unsecured debt at “AAA” rating.

True Sale

To carry out a sale of receivables the seller must notify each of the debtors in question that the receivable owed by them has been sold; this requirement could be particularly onerous where there are a large number of debtors or the debtors change frequently (for example, in a trade receivables structure). Indeed, regardless of the administrative issues of giving notice to debtors, originators will almost invariably seek to avoid giving notice, as this may affect their continuous business relationship with the debtors.

In some jurisdiction, notice may be given in fairly innocuous form by way of a note on a periodic accounts statement, which may be relatively cheap and easy to carry out.

The most common legal method used of effecting a sale of English law governed receivables is that of **assignment** with the alternative of **novation** used in frequently, as it entails obtaining the consent of each customer, and would operate to pass any obligations of the originator under the receivables contracts to the SPV. It is an absolutely & irrecoverable assignment of all its rights & obligations (of issuers).

It may also be necessary to address **commingling risk** if cash collections will still be paid to the originator after the sale, to prevent the collections being lost to investors on insolvency of the originator if they are commingled with other monies of the originator. Generally speaking, only mortgages & charges are of particular relevance to a securitization, as liens.

Negative Pledges

A further issue of relevance in considering a secured loan is the potential existence of negative pledge clauses in the originator's current loan or capital market documentation. Negative pledges are often found in unsecured loans and usually consist of an undertaking not to create security over assets of the originator without seeking the consent of the relevant lender, or granting the lender equally ranking security (usually, except for certain permitted arrangements relating to the originator's day-to-day business). Capital markets negative pledges may in some cases be less restrictive and only limit the ability of the originator to create security for a subsequent issue of debt instruments.

RATIONALE FOR SECURITISATION

1. CAPITAL ADEQUACY PURPOSES

Finance can be raised outside the regulatory balance sheet, as the essence of transaction is to replace receivables with cash, which carries a zero risk weighting for capital adequacy purposes.

Consequently, the issuer can release capital, in giving further loans or for financing enhanced operations, that would otherwise have to be held against the risk of default on the assets.

Further it will boost Return on Capital resulting from reduced rate of capital employed.

2. OFF BALANCE SHEET FUNDING –

Generating immediate receipts for accounts receivable by securitization may enable the company to survive a short term liquidity crisis.

3. **OFF BALANCE SHEET FUNDING** - also enable issuer to rely on the reduction in its gearing in order to raise further loan finance/debt capital.

4. BALANCE SHEET MANAGEMENT

Securitization can be used to restructure the balance sheet of the issuer, as the finance raised will not appear, in whole or in part, as an additional item on the balance sheet of the issuer or in its statutory accounts and the assets securitized will be removed in whole or in part from the balance sheet.

5. FUNDING DIVERSIFICATION

The segregation of receivables from the issuer may enable funds to be raised from investors who would not normally lend to the issuer in question, due to the issuer being perceived as a bad credit risk.

6. BANK LIQUIDITY

Securitization of assets/loan portfolio can be used, in case of banks, to increase the liquidity of assets on the balance sheet of a financial institution issuer enabling compliance with bank liquidity ratios with Central Bank.

7. TENOR

Matching funds for long term investments could be obtained (for example 10 or 15 years) exceeding maximum term of loans usually available from banks and from other capital market debt instruments.

8. COST OF FUNDS -

Unusually, the original form of the receivables (loan instalments) cannot be readily marketed, whereas the securitization process will allow funding in a form which is easily transferable and marketable to a far wider range of investors, thus improving the all in cost of funds to the originator or the amount of finance which can be raised.

9. STRATEGIC PROFILE

If the originator has not previously issued in the capital markets, it may be an unknown name to capital market investors, and a securitization process attracting a high credit rating may enable the originator to launch itself in the capital markets successfully and achieve a good reputation, enabling further issuance on a full recourse non-asset backed basis.

10. TRANSFER OF RISK

The transfer of the receivables also has the effect of transferring the risk of losses on the receivables due to defaults, leaving the originator with the risk of loss only on that portion of the risk which is retained as credit enhancement.

11. SYSTEMS

It has also been perceived that the analysis of the originators' systems, underwriting procedures and day-to-day administration which is required for the transaction may actually prove beneficial for the originator subsequently in terms of continuous business efficiency.