Types of securitization instruments finance essay

Food & Diet

Securitization defined as process by which loan is made into tradable security. It becomes tradable security when against it any negotiable instrument or bill of exchange is issued which is backed by the loan or receivables

" Securitization generally refers to the sale of assets, which generate cash flows, from the institution that owns them, to another company that has been specifically set up for the purpose, and the issuing of notes by this second company. These notes are backed by the cash flows from the original assets."

The institution is called originator which issues the the same and own the assets backed by it. Another party to it is Special Purpose Vehicle which purchases the assets and that generate cash flows. The special purpose vehicle will hold the assets that are sold by originator to SPV as collateral which are later sold to investors.

Structure of Securitization :

The receiver of high net worth receivables sell them to specially formed company named Special Purpose Vehicle and it sells the same to other investors as sale mode transaction against the collateral of receivables.

The SPV provides the security to investors in the process by issuing special note or bond or borrowing from bank as security to investor.

The SPV pays the servicing fee to it and authorizes the originator to collect funds on behalf of special purpose entity which is used to pay the principal and cost of it for the funded loan. The proceeds are latter invested to earn return.

The SPV is not the subsdiary of origniatory thus it is not the company whose shares are held by originator but the charitable trustee or any other than originator.

To ensure the recieavles will be sufficient to repay the amount owed to investors on time, other arranegments are made to ensure sufficient liquidity in the process like Credit Enhancement or guarantee by third party or subordinated loan

Rating agency often rates the note receivables or the process. The higher the rating, the higher would be funds obtainable.

The SPV that generates the income through additional money earned through recieavles to originator to earn profit. SPV pays the same to originator as the fees

Below is a figure which perfectly complements our summary:

The originator is very important element of this process because it can be real person or legal one which basically initiates the process by sorting out the assets which are to be securitized against the same.

Motives for Securitization:

Advantages to issuer

Funding cost: Depending upon the rating of the fund, cost of fund is charged at low. For Instance a cash flow is rated AA and second one is rated BB , the one with AA ratting will be charged lower than the latter one.

Reduces asset-liability mismatch: From the financial funding exposure point of view , securization offers great opportunity to elimate the issue of duration and pricing concerns at large. Securization offers high cost saver to issuer. For instance banks can utilize it efficiently because they have a large amounts of recievales and collaterials as securities thus they can issue securities backed by these assets and let them to be self funded asset book.

Lower capital requirements: There are very stiff requirements of the regulatory and legal pertaining to leverage capitalization. The recieavles and assets under securization will considered earning assets and thus removing from balance sheets for accounting purpose.

Profit: Given the fact that the specific business block for whose profit is not certain or not yet emerged then the assets of those can be securitized and immediate cash flow can be realized and thus locked in profit for this block results.

Transfer of risk: Securitization process makes it easy to transfer the credit, liquidity & reinvestment easy to transfer to those who accept it on condition to receive profit.

Off balance sheet: Securitization as implied by derivates which are referred as off balance sheet items which classifiy the same as zero sum impact on balance sheet. There is general requirement internationally that records the derivatives at fair value in the financial statements i. e Balance sheet.

Earnings: Securitization makes the oringinator capable to bounce back without addition to the firm whereas the true sale takes place between the orginiatory and special purpose entity. It is to highlight that the earnings of the SPV increase the wealth with parent company.

Admissibility of bad debt:

Future cash flows may not result in perfect recovery because there is also some bad debt in the receivables. Securitization thus makes it possible to get the immediately cash against those too in advance.

Liquidity: Securitization simply provides you the future cash flow now thus increasing the liquidity with the company. Thus it will be available with the company to spend and make investment from the same amount thereby increasing the reinvestment return

Disadvantages to issuer

May reduce portfolio quality: If the AAA risks, for example, are being securitized out, this would leave a materially worse quality of residual risk.

Costs: There are costs involved in the securization process raning from legal fees, system cot, rating cost, underwriting fees and administrative cost.

Size limitations: It involves huge amount of funds to structure the same to be efficient if otherwise the funds are less then the process with lesser funds.

Risks: It is structured transaction thus it is vulnerable to risks such as prepayment, credit loss and reinvestment

Advantages to investors

A chance to earn higher rate of return

It usually involves high quality assets back because there are very stiff requirements for securitization process, such as attaining high ratings, maintaining liquidity and diversified portfolio.

Portfolio diversification: It is worth narrating here that large institutional investors and corporate investors tend to invest in the securitized funds because returns from their this investment is not related to their equity or bond side investment due to un-correlation between the investment portfolio in the market.

Isolation of credit risk from the parent entity: Securitization process desegregate the parent and SPV rating. Regardless the company's rating; SPV may be issued separate rating. Suppose the bank's rating is not good but the portfolio of borrower of bank is of high quality thus there are less chances of default of the same and investors in securitized asset are more willing to have them in their portfolio.

Risks to investors

Liquidity risk(Credit/default)

Defualt risk meant inability of borrower to repay the principal and interest payment on due period of time. An indicator of security's high risk is its credit rating or credit worthiness. High risky portfolio of borrowers receives lower ratting then those of ones with less risky portfolio.

Prepayment/reinvestment/early amortization: The securitized assets are always prone to early amortization and reinvestment risk. These risks arises out of huge payouts of the borrowers thus causing premature confession of liability and affecting the rate of return. This also affects the gap between the spread that bank pays and collects from borrowers and investors respectively.

Contractual agreements: It is generally perceived that the manager who deals with investors and quote the rate which is solely dependent upon the performance of the underlying asset. Now question arises if the underlying assets become risky from the investors perspective i. e default ratio or high bad debt ratio then the price of portfolio.

Types of Securitization Instruments

Pass Through Securities: PTS is also called Participation Certificate because it bears ownership of the investors in the underlying asset. The amount received on account of the period payments including principal and interest payment which is collected by SPV and is passed on to the investors.

Tranched Securities: In this type of security, the amount received as cash flows in tranches and the same is received as first priority with subsequent payments in latter tranches.

Planned Amortization (PAC) Tranches: It is a type of security in which sinking fund is created which controls the prepayments that are beyond the limit thus ensures the stability of cash flows. This offers lower yields while comparing them with those without sinking fund.

Z-Tranches or Accretion Bonds: In this type of security, interest payment is not paid in the period in which accrued interest is higher in lock out period. Once the period is over, it starts paying out the interest payments and principal.

Principal Only (PO) Securities: These type of securities are issued on discount such as T-Bills. Thereof investors receive their principal in installments. The bonds are issued at huge discount rate and thus remaining amount is paid till the differential payment is made till the face value.

Interest Only (IO) Securities: These type of securities have no any specific face value thus they offer only interest components to the investors while cash flows diminishes and is repaid.

Floater and Inverse Floater Securities: They are securities which pay interest payments which is dependent upon the performance of any index or benchmark i. e Kibor. Floater and Inverse floater are two opposite type of securities. In Floater, the interest payment moves in exactly the same direction as benchmark rate moves and opposite is true for Inverse Floater securities.

Types of Securitization Structures

There are several types of Securitization structures: type of securitization structures include:

Cash vs. Synthetic Structures: Cash structure is the world's most followed structure in this field of specialization. In cash Structure, originator sell its assets in exchange of cash immediately. In Synthetic structure, the originator keeps the title with itself and investment is unaffected on the assets. In simple words, he does not put their assets on sale rather the risk/reward is merely transferred being derivative transaction.

True sale and Secured Loan Structure: In true sale structure, originator sale the assets in true sprit which involve transfer of title and legal interest in the assets. In SLS, issuer takes the secured lending as loan. Fixed and floating charges are issued to investors to protect their stake and rights over the undertaking of issuer and trustee is empowered to take the possession of assets.

Pass Through vs. Collateral Structure: The SPV issues participation certificates to investors that represent the direct participation of them thus they are exposed to performance of assets. Investors receive return when there is any cash generation from those assets and so is true for risk involved in these assets. To mitigate the risk of delay payment credit enhancement is opted.

Pay through/Collateralized mortagge obligation(CMO) is another name of collateral structure in which SPV keeps the assets with it whereas charge is given to investors only not the assets. The special purpose entity issues the debt against those assets which are transferred by issuer.

Discreet Trust vs. Master Trust: It is a type of structure in which Special purpose vehicle identifies a specificil pool of assets for investors to participates and thereby earn from cash flow pool thus it is called discreet. While Master trust is creation of larger fund backed by many pools which are transferred for several investors in which funds raised are not greater than the assets transferred this also covers the repayemtn structural and tenure issue to reciprocate.

Conduit vs. Standalone Transactions:

In this type of structure the purchaser or originator collects the assets from different orignators and keeping them backed to debt he issues commericial paper. It is for short term duration and thus it requires short term financing frm the banks. In stand alone strucute, the conduit sources the assets from single originator thus securities are issued keeping in view the maturity of asset pool.

ISLAMIC SECURITIZATION

Islamic securitization can best be defined as process which satisfy the conventional asset backed securitization and parallel adherence to Islamic laws of economic finance. The rights of cash flows are transferred to SPV from originator thereby issue notes to investors as sold.

In this system, SPV becomes the trust and thus holds the assets in capacity of fund manager. The security issued through Islamic securitization is called Sukuk in official terms which is issued by SPV and the income is derived from the funds being received against the funds hold as underlying asset.

Islamic finance encourages dealing in assets not the cash as commodity, therefore it is permissible under Islamic finance to securitize the assets provided they adhere to the guidelines of Islamic Finance.

The theme is that Islamic securitization can replicate the process of conventional securitization with joint supervision of Shariha and Fund manager. If any thing which is not in compliance to Islamic law then regardless if the process is crystal clear, the securitization stands null and void in the eyes of Shariha. For example, if underlying assets are credit cards and conventional mortgages and income from them will be shared with investors soon shall it realized, the process is null as credit cards income do not comply with Shariha because it has interest bearing instruments attached with it.

If investors are investing in assets then the ownership of the same be transferred to them too if it has to comply with Shariha guidelines. It must be noted that transfer of title to assets is not necessary or compulsory but the rights to collect them, access them and right to know them is given to investors that justifies the shariha rules. Investors are supposed to bear risk of loss and profit to underlying asset as they are enterning into ownership contract.

Adapting the Principles of Islamic Finance to Securitization

Islamic securitization requires two stage evaluation. Firstly Shariha compliance of assets/portfolio and returns from the same, secondly the structure of transaction which includes credit enhancement and liquidity management.

The first standing principle is simple Islamic securitization in no way accepts the income that involves interest bearing. It has to be structured in such a way that the investors are exposed to some sort of business risk in relation to their share in investment. Therefore it is made compulsory for the investors that the return must be commensurate to the risk they bear.

Islam disallow debt trading, management of prepayment risk and other conventional tools which can cause customers who are income only-centered not to invest with them. Shariha requires procedural and objective evaluation of securitization process to carry on process and prohibits elements of gharar, interest, haram and encourages real economic participation with mutual risk sharing, profit sharing and benefit of entire society.

Securitiziation has to adhere to following princples of Islam to be shariha compliant:

The purpose of raising funds through securitization must be genuine as not to defraud the investors. And the assets which are under lying in the process must be clearly identifiable and revenue from them must be separable from those which are not under umbrella of securitization. The assets under consideration must not be consumable.

Each investor must receiver their share commensurate to their share of investment and risk exposure in the assets. Therefore if assets earn profit, that is sharable other wise you can not fix the rate of return on their investment.

The security must not be backed bu the debt or prohibited activity as prohibited by Shariha. It must not be involved in any kind of haram, unethical or exploitation of natural resources with or without non-productive investment

The transaction must involve the risk factor and not just the mere return. It must involve compensation for the investor and exposure to risk in the assets under securitization. It must not hold debt as underling security and mere exchange of money and interest on that. It means transaction must not be mere debt and risk free exchange of return.

Investors must hold unsecured payment obligation and that be unconditional investment. The principal cannot be guaranteed that the same will be redeemed in full or in part.

Investors must be given hand in the ownership of underlying assets

The proceeds from investors can not be invested in cash based instruments or interest bearing notes. Without any exception, even the return from that can not be reinvested in any short term cash based instruments or interest based debts(bonds).

The turnover must be kept low to avoid any un-utilization of assets. Speculation of underlying assets and payment obligation is to be prohibited without any exception.

Islamic takaful should be sought instead of conventional insurance for the credit enhancemenet and liquidity management.

There must be Transfer of ownership and direct participation in the assets

Exclusive linkage between the cash flows and underlying asset has to be developed.

Islamic scholars are of view that credit enhancement be allowed on condition that does not change the over all structure of securitization process.

In conventional securitization there is tranche subordination which is not allowed in Islamic law but there is option in Islamic Law the lease-buyback(Ijaraha) transaction. The issuer gives partial ownership rights of underlying assets to investors with respect to risk exposure of their investment in the portfolio thereby leasing back the same in exchange for fixed rental payments which is conditional on repurchasing the portfolio at already specified price on future date. This covers the reinvestment risk of the portfolio.

Islamic finance ruled out that interest bear financing instruments are allowed on the basis of partnership not on interest bassis. The point is to refute the concept of interest in all the ways.

It is creation of sukuk which shows evidence of ownership on assets i. e tangible and intangilble, fixed or revolving what ever they be but must be productive cash flows within finite period of time.

Structure of Islamic Securitization

There are following parties involved in the Islamic securitization transaction process.

The Originator: It is the issuer of sukuk and is authorized to use the funds against selling of assets to SPV. It may delegate any other institutuons to carry on the issue as under writer.

SPV: It is referred as Issuer of the securitization issue. It is entitity established to manage issue and purchases the assets from originator from the funds thereby issuing sukuk.

Investment banks: They are agents and underwriters of the sukuk. They manage to raise funds on commission only base.

Subscribers of Sukuk : They can be like any thing for instance banks, non financial institutions who basically invests in the sukuk.

In its basic concept, originators would sell existing or future revenues from lease

receivables (asset-based), " sale-back profit" (debt-based) or private equity from a portfolio of

Islamically acceptable assets to a special purpose vehicle (SPV), 30 which refinances itself by

issuing unsecured securities to market investors, who are the " capital market corollary" to a

singular lender in Islamic finance (see Figure 3). They assume the role of a " collective financier" whose entrepreneurial investment does not involve guaranteed, interest-based

earnings.

If we look at the structure of both conventional and Islamic securitization there it can be depicted there exists no any difference from structural point of view involving parties to it. Originator sells the assets (existing or future) from a portfolio of Islamically aacceptable assets to SPV, which then refinance itself by issuing securities to investors that are unsecured by nature. The proceeds are then passed on to originator. Like in Ijara sukuk, SPV raises funds to purchase the assets and the same must be equal to purchase price. Investors have equity interest in the SPV in Ijaraha sukuk structure in other words they have direct ownership in the assets. The SPV thereafter leases back to originator. SPV must match the payments with its obligation under Ijarah sukuk and it receives lease payments from seller. Upon maturity, special purpose entitity redeems the assets to originator and liabilities are deducted at source because they are owned by SPV. If any portion of income earned is categorized as haram or unethical then the same be given in charity without any objection to it.

Figure Process of Islamic securitization:

Following figure depicts the process of Islamic securitization based on Ijaraha:

Islamic securitization will best be categorized as monetization of assets underlying in the securitization process where as conventional counter parts best be defined as mere sale of debts. The process of issuing sukuk is kind of sale of share in assets. Islamic alternative offers almost the same benefits as conventional ones have to offer for instance enhanced asset liability management, term structure transformation, better management and control over assets.