

Securitization process motives and risks essay sample

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Securitization is a global concept aimed at changing an illiquid asset into a security (Giddy, 2001). It is a corporate function used by various corporations for various reasons. Financial institutions and various corporations have continually used the concept to increase cash inflow and reduce the risks associated with illiquid assets. The complex financial process involves a framework through which, a corporation's illiquid assets are classified as collateral for third party investors. Therefore, a corporation that undertakes a securitization process is simply turning its illiquid assets into securities through pooling the resources (assets) together and selling them as asset-backed securities (Giddy, 2001). Ideally, this happens through carefully packaged financial structuring. In essence, assets that can generate a viable flow of cash for a corporation can go through the securitization process. For instance, financial institutions can turn underlying loans, which are assets in their financial records, into securities and sell them to investors. Basically, this implies that the ownership of the assets goes to the investors. From a financial perspective, a security is tradable, and it has more value than an underlying loan (Giddy, 2001). In this respect, financial institutions seek to expand the value of their illiquid assets by undertaking the securitization process.

Having begun in the United States of America in the 1970s, the financial concept has gone through transitions to become a popular business process in the global corporate world (Alles, 2001). The inception of securitization saw the financing of mortgage-backed securities. The process has since expanded to include other illiquid assets like car loans, mortgage loans and credit card loans (Teasdale, 2013). Indeed, securitization is a complex

integrated financial process that involves integral parties. The process involves diverse concepts and elements that define its functionality and the roles played by the fundamental players. Understanding the integrated functions of the participants and the basic components involved in the process is fundamentally vital in comprehending securitization. Having an in-depth description of the process will certainly unearth the basic concepts and risks involved in it.

Description of the securitization process

As mentioned as earlier, securitization refers to the transfer of a corporation or financial institution's illiquid assets into asset-backed securities for the purpose of enhancing their value. Ideally, liquid assets have more value in a company than illiquid assets (Fabozzi and Kothari, 2008). Hence, it is worth noting that pooling the assets and turning them into securities is not a simple exercise, but a complex interplay of financial fundamentals that define the process. Of great importance in a securitization process is the key players or parties involved. Depending on the nature of the pooled assets, the parties involved can greatly vary. The players in a securitization process have different roles, and relate differently. The pertinent participants in a securitization process are analyzed below.

Originators refer to the corporation or company whose assets are under securitization.

An Aggregator refers to the party that buys similar assets from a number of Originators to come up with the pool of assets for securitization.

The Depositor obtains the pooled assets from the Aggregator and deposits them into the SPV (Special purpose vehicle). It is the Depositor who comes up with the SPV.

The Issuer gets hold of the pooled assets from the Originator and provides a platform for the pooled assets to be sold to the investors. The Issuer transmits the certificates to the Depositor in exchange of the pooled assets. The Issuer gets the pooled assets from the Depositor, who in turn creates the opportunity for the investors to come into play. In a securitization process it is the Issuer (a specified company) or SPV who holds the pooled assets and acts as the means of cash flow for the pooled assets (Dembiermont, 2010). The purpose of the Issuer is to ensure that the pooled assets in the securitization process are distinguished from the other assets belonging to the Originator. Distinguishing between the pooled assets and other assets is imperative in case the Originator is declared bankrupt. If the Originator is declared bankrupt, the assets transferred to the SPV cannot be affected by the bankruptcy.

The Underwriter's responsibility is to buy the pooled assets' certificates from the Depositor and sells them to the investors in play. The amount paid to the Depositor by the Underwriter goes to the Originator. The amount is basically the purchased price of the assets. It is noteworthy to highlight that the Underwriter is generally an investment bank (Teasdale, 2013).

The Investors are the ones who finally buy the certificates issued to the Issuer (Special purpose vehicle). Based on the terms of the securitization

process, the Investors are entitled to receive monthly interests from the SPV. The amount of interest paid to the Investors depends on the type of certificate purchased by each investor (Teasdale, 2013).

Moreover, the capacity of the Investors to enjoy other repayment benefits definitely depends on the degree attached to the pooled assets' certificates. It is significant to note that the SPV distributes the amount of monthly repayments to the Investors from the pooled assets' cash flow.

The Trustee is responsible for managing the SPV and ensuring that the rights of the Investors are not violated in the process. The securitization process defines the rights of the Investors, which should be followed. Ideally, the Trustee mandate is to calculate the cash generated from the pooled assets and submitting the SPV's net proceeds as returns to the Investors.

Servicers are the ones who collect the cash due from borrowers in the pooled assets. Once the servicer collects the money from the borrowers, the money goes to the Trustee who in turn distributes the money to the Investors. In a securitization process, the Servicers collect fees that service the pooled loans. In this respect, most Originators take charge of the servicing process in order to have the complete payment on their securitized assets.

Additionally, the Originators seek to have servicing rights in order to receive income from the servicing fees of the loans. Some originators may opt to outsource the servicing functions or put up the serving rights for sale.

From the description above, it is precisely clear that securitization involves a complex integrated process that needs to be followed to the latter in order to

achieve its objectives. The different participants in the process have diverse roles and obligations that contribute significantly to the aims of securitization. This means that the interests of one party affect the interests of the other. In this case, it is imperative for the parties to follow the diligence deserved in order to enhance the integrity of the process.

True Sale Status

The securitization process involves a concept called “bankruptcy remote”. The concept implies that the pooled assets in the securitization process are secure in case the company securitizing the assets becomes bankrupt. In order to realize the “bankruptcy remote” status, the pooled assets from the originator to the SPV should be done in a “True Sale” mode. Without a true sale mechanism, the investors in a securitization process are at risk of defaults in respect to the pooled assets. In case of an originator’s bankruptcy, the originator can claim the pooled assets as part of the bankruptcy realm. Therefore, a true sale is imperative in according investors the appropriate protection in the process. A true sale is also significant in protecting the originator. Once the pooled assets become the jurisdiction of the SPV, investors can only claim payments from the SPV and not from the originator. Hence, a true sale plays a dominant role in the securitization process of illiquid assets.

Pooling and Servicing Agreement

The PSA is an important document used in servicing a securitization process. (Fabozzi, 2011) The document entails the relationship between the different

parties in the process. Every party has a role to play in the process; hence it sets the standards of operation in the financial process. Given the complexity of elements in securitisation, the document becomes an integral component in governing the process.

Indeed, securitization involves a complex interplay of processes that require the participants to articulate the issues involved vehemently. Every player is significant in realizing the objectives of securitization. Through the pooling and servicing agreement, it is significant for the main players to foster a feasible financial relationship in order to maximize the benefits of a securitization process.

Motives of SecuritisationThe decision by a firm to undergo securitization stems from a myriad of motives. The fundamental need to undertake a securitization process is for a firm to maximize the value of their assets. To begin with, a financial institution can choose to turn its illiquid assets into a security because of the strategic benefits of the move. A corporation's management can base their motivation to securitize its assets from a strategic tools perspective. It can base the securitization decision from the need to provide strategic decisions in respect to reducing funding costs and building core competencies in specific areas of interest (Fabozzi, 2011). For instance a financial institution can specialize in originating and servicing, as opposed to financing. Moreover, a business enterprise might decide to increase its business jurisdiction without necessarily expanding its capital proportion in the same way. Depending on a financial institution's core competencies, it can engage in securitization of its illiquid assets to expand

their market jurisdictions. Through the value of assets created by the securitization process, institutions have the opportunity to develop new lines of businesses (Teasdale, 1994). This implies that a business enterprise can capitalize on securities to expand its franchise without concentrating on its capital base's increase. Therefore, a firm's desire to develop new business horizons is a significant motive behind securitization.

Increasing liquidity is another pertinent motivation behind a firm's securitization. From a financial point of view, securities have a more lucrative market value than illiquid assets. Given the diversity of the economic environment, it becomes increasingly important for banks to obtain funds from asset-backed securities, which were otherwise not possible within the illiquid form of assets (Fabozzi, 2011). More importantly, financial institutions opt for securitization processes because the broad context of capital suppliers increases the liquidity ratio. Consequently, this will lead to an improvement in the turnover of assets. The asset turnover is directly proportional to the distribution capability of a financial institution. Therefore, the desire to increase the revenue index of a company is a huge motivation towards the emphasis on securitization.

Asset-liability management drives institutions to enter into the securitization idea. The motivation behind this is to ensure that there is a match between a firm's assets and liabilities. A financial institution with limitations on its ability to grow because of asset-liability mismanagement can choose to securitize its assets to enhance the rating of its deals (Fabozzi, 2011). For instance, a company that is not well positioned to raise extensive

international borrowings can capitalize on securitization to enhance the rating of certain deals above the institution's rating. Consequently, this plays a huge role in enhancing the management of asset-liability tenures. It is also worth asserting that through the securitization process, it is possible to create securities that help in the management of assets and liabilities. The process enhances the flexibility required in structuring the timings of cash generation to each security under securitization.

Securitization is instrumental in the diversification of assets across companies and industries. This implies that financial institutions like banks can choose to take the loans of some of their customers off the balance sheet to provide new funds to the customers (Fabozzi, 2011). This is aimed at diversifying the asset portfolios of financial institutions to include more individuals and companies. The diversification of assets through securitization makes it possible for a firm or corporation to minimize the concentration of risks. This is a huge benefit to the company's growth and development.

Capital requirement is an important aspect of financial institutions. Based on a capital requirements perspective, financial institutions are required to maintain a certain ratio of capital-to-risk-weighted-assets according to the requirements of the Basle Committee. Hence, the guidelines are often a motivating factor in determining the decision to securitize. Securitization as a capital requirement leads to a significant rise in the leverage ratio to a financial institution. A company's leverage ratio is essential in determining its Return on Equity (ROE) (Kothari, 2006). Ideally, the higher the level of

leverage the higher the Return on Equity; hence, contributing significantly to capital relief for a financial institution. Consequently, it is significant to assert that capital requirements are a significant motivation to securitization.

The need for a firm to manage its loan portfolio effectively may necessitate the securitization of its illiquid assets. In respect to financial standards, a well managed loan portfolio makes it possible to maintain a low cost of credit enhancement. In order for this to take place, there has to be a transparent portfolio management by the firm in question to investors and rating agencies. As a result, the originator in a securitization process has the opportunity to develop the quality of loan origination (Kothari, 2006). Thus, it is evidently clear that the motives behind securitization are varied, and a firm wishing to go through the securitization process puts into consideration the various issues associated with the process. It is important for a firm to take deliberate steps in realizing its goals and objectives in the process.

Risks arising from securitization

Despite the benefits associated with the securitization process, it is precise that there are several risks arising from the process. The risks cause potential setbacks in the performance of the parties involved in securitization. Based on the multifaceted process, it is highly probable that the key players in securitization might face diverse risks. Default risk is one of the risks that might arise from the securitization process. This refers to the incapacity of meeting the payment schedules as per the servicing agreement (Kothari, 2006). When the payable interests are not delivered in time, then

the investors are subjected to default risk. According to the stipulated rules in the servicing agreement, the investors are entitled to interests within a specified period of time. Failure to adhere to the maintenance of the asset-backed securities in the securitization process exposes the investors to default risks. The credit rating of a security in a securitization process is integral in defining the degree of default risk involved.

Interest rate risks are also common in affecting the structures of a securitization process. It is worth pointing out that the price of asset-backed is proportional to the existing interest rates. This implies that the price of an asset-backed security is significantly affected by the prevailing trends in the interest rates. Fluctuations in the interest rates have a huge impact in the financial performance of the pooled assets (Ali and Coyne, 2008). The interest rate risk involved implies that a drop in the interest rates reduces the yield accrued to the asset-backed securities. A critical approach at interest rate risks shows that the loans that have a high sensitivity to interest rates are mostly affected than those that have a low sensitivity. Fluctuating changes in the economy certainly have a high probability of posing risks to a firm's asset-backed securities; hence, affecting their performance. Generally, if interest rates are low, it is possible that the value of the pooled assets will be affected.

There is also the possibility of a servicer risk in a securitization process. The risk arises from the inability of the servicer to articulate the servicing functions well. The collection and remittance of cash by the servicer might be delayed, thus exposing the complex process into risks (Ali and Coyne,

2008). The incapacity of the servicer to balance the collection of payments increases the likelihood of repayment risks in the securitization process. Of course, the poor servicing of cash flows by a servicer have a huge impact on the financial performance of the transaction. For instance, in the event of insolvency in the part of the servicer, investors in the financial transaction are at risk of losing their entitled amount. In order to avoid this risk, it is significant to have a backup servicer in the process. The parties in securitization need to have deliberate frameworks of enhancing the overall servicing portfolio in the process.

Underwriting risks refers to the incapacitation of the underwriter to sell the securities under the underwriting agreement (Teasdale, 1994). In such instances, the underwriter has to wait until the securities can be sold. In order to mitigate the risk, the underwriter and the issuer can come to a consensus and agree on favorable terms of servicing the securities.

Basically, this involves paying a higher price to the issuer, who in turn sells the securities entirely through the underwriter. Through the relationship between the underwriter and the issuer, the issuer is able to sell the securities using the underwriter's details. The ability of the issuer to sell the securities stems from the fact that the issuer is insulated from the incapacitation of selling the securities at a favorable price. It is worth asserting that the underwriter is entitled to a profit after the sale of the securities.

A lapse in a securitization process can cause reputational risks to either of the parties involved in the process. A reputational risk refers to the way a

corporation relates with its internal and external stakeholders (Ali and Coyne, 2008). In case of a flawed process in the process of securitizing the assets of a specified company, the party involved in the process might find itself entangled in a reputational risk. For example, if an originator is declared bankrupt or fails to conduct its servicing function well, chances are that it will destroy its reputation. The relationship between the originator and the investors will be compromised especially if there is no clear consensus between the parties. The corporate image and identity of the firm will be jeopardized; hence, tainting its reputation in the market. Therefore, it is important for the parties in the securitization process to undertake their functions with sheer professionalism in order to avoid any instances of reputational risk.

Risks precipitated by a securitization processes have the capacity to affect the functioning of the various structures in the process. Risks affect the interests of the participants in a securitization process; hence, the need to put viable measures of mitigating the risks. Without a viable framework of managing the risks involved, it is highly likely that the securitization process will be jeopardized by the risk factors. Thus, it is extremely significant for each of the players in the securitization process to put deliberate efforts of alleviating the possibility of risks.

Conclusion

In conclusion, it is notable to assert that securitization is an imperative process in today's corporate world. The need to increase the value of assets

in a firm is the most fundamental element in the securitization process. Precipitated by the urge to turn illiquid assets into securities, a financial institution involves other participants in undertaking the securitization process. Indeed, the process of securitization is complex, and it requires the parties involved to play their diverse roles amicably to avoid the risks involved in the process. The financial obligations by every party are critically essential in realizing the aims and objectives of the process. The complex interplay among the key players in securitization is significant in unearthing the financial concepts involved. The motives behind the securitization process are extremely diverse, and have numerous benefits to originators and investors.

Without a doubt, securitization of a firm's assets is imperative in the development of opportunities for the originator, and improving its capital requirements. Asset liquidation is achievable through the process and enhancing its performance in the market. The originator in the financial set up has an opportunity to expand its market jurisdiction and enhance its assets diversification. Securitization also presents an opportunity to increase the value of the investors by making them key stakeholders in the operations of the firm securitizing its assets. Given the ability of the process to expand the capital markets, it makes it possible for the realization of new business and borrowers in the financial structure of the market.

However, it is vital to note that the process has its own challenges. There are risks that arise from the establishment of the securitization structures in a market. Often, the risk factors cause devastating effects in respect to the

performance of the pooled assets in the securitization process. This implies that a slip up by any of the participants in the financial process might bring various risks, which consequently lead to negative effects. Thus, it is vital for securitization to have feasible frameworks of risk management to ensure that the process achieves the much needed success.

Reflective log

Learning about the securitization process has enabled me to have a firm grip of the financial obligations mandated to firms and corporations, and the necessary steps to take in ensuring the feasible articulation of operations. Through extensive reading, I have expanded my knowledge on corporate financial functions and the complexities involved in various processes. Particularly in the securitization process, it is without a doubt that the financial process is an integral corporate process.

What I have achieved

Undertaking a research on securitization has motivated me to learn more about corporate finance and the fundamentals of finance management. I have been able to unearth significant concepts about the securitization process in financial institutions and the relationship between different parties involved. I have achieved my goals and objectives in respect to the development of an in-depth understanding of managing assets and adding value to a company. Additionally, I have achieved in dissecting between the complex structures of the process and learning how the process works from inception to the actualization of objectives set. Indeed, the research was an

eye opener and a motivation for me to have more knowledge in the financial management of businesses. I have also achieved in developing a viable framework of interpreting financial structures and, consequently, understanding when undertaking a securitization process is necessary.

Progress made

I have certainly made progress in expanding my knowledge about the different players in the operations of a business. Initially, I could not articulate clearly the functions of the different players in a financial interplay between organizations. Thus, I have improved in my ability to distinguish between the roles and obligations of various stakeholders to a firm. I have made progress in my comprehension of capital functions of a financial institution. I have precisely developed in the area of risk management and the loan portfolio. In this respect, I have tremendously understood the elements that precipitate the need for companies to undertake the securitization of their assets.

Development of new skills

Indeed, I have developed new skills during the course of my research and study. I have learned how to critically analyze issues and concepts to develop a viable argument. This has enabled me to understand the need to look at points from a wider perspective in the generation of logical ideas. Moreover, I have developed the skill of integrating concepts and gathering information from different sources aimed at enriching the content of research. I have learned that research is not one-sided, but it should contain

extensive work from various sources. Through this, I have developed the skill of analyzing concepts from their historical perspectives to the present trends, and how the transitions have affected the elements involved. For instance, I have grasped how the financial concept of securitization has changed its structures since it was first established in the 1970s to the present. Furthermore, I have developed on how to distinguish between concepts and how to apply them in a practical scenario.

Future use of the skills

The skills are extremely important in my growth and development as a student and a professional. As a student, I will capitalize the skills in developing my understanding in other academic realms and disciplines. The acquired skills will certainly motivate me to understand more academic concepts as I put them into practice. I will use the skills to sharpen my academic capabilities and improve my performance. As a professional in the work place, the skills will come in handy in developing my assessment and analytical skills. They will enable me handle diverse work-related environments and issues in a professional way. I will be in a position to undertake my duties with utmost proficiency by practicing the skills to the latter.

How I have changed my learning style

I have changed my learning style by incorporating critical and creative skills in my study. Through evaluating ideas critically, I have developed a habit of comparing different frameworks and conceptions before making conclusions.

Initially, my learning style did not always involve deductions based on critical analysis, but I have integrated into a more critically-centered learning style. This has certainly changed the way I approach conclusions after a study; I subject myself to a reflective mode to internalize on the main points in a piece of study. For example, while studying about the securitization process, I did not only study about the process involved in the concept, but also the roles and obligations of every participant. In other words, I have adopted an open mind-approach while studying. This is vital in having an in-depth perspective of the diverse elements in a study.

Effects of continued practice in the new skill

As it is widely acknowledged that practice makes perfect, a continued practice of this new skill will definitely transform my ability to comprehend multiple concepts. It will also sharpen my understanding of key concepts in my area of interest. For example, as an aspiring corporate leader, I believe that the skill will enable me to learn more about basic management procedures and how to articulate them in various scenarios. It will build my capacity to make decisions concerning management practices and how to strategically institute corporate functions. Mastering this function will elevate me to significant levels of analyzing the internal and external mechanisms of a business environment. Thus, a continued practice of this skill will ultimately play an instrumental role in diversifying my scope as a student and a professional.

How to improve the process of research and learning

Undeniably, research and learning are dynamic tools that need constant improvement. With constant improvement, I will be in a position to undertake learning and research in virtually every area of interest. In this respect, I will need to develop feasible ways of improving the much-needed elements. Firstly, it is important for me to have a desire for more learning and passion in the field of research. Through this, I will be in a position to undertake significant strides in improving my research and learning abilities. In a corporate scenario, it is evident that there will be new dynamics in the securitization portfolio, and this will require more learning and research to understand them. In addition, financial issues arising in business environments will require feasible research to develop solutions. Therefore, developing passion will be significant in improving the process of research and learning. Also, embracing new ideas and learning experiences will also contribute significantly in expanding the processes of learning and research. Generally I will take deliberate and purposeful actions to achieve goals and objectives

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