

The thesis and statement of the problem finance essay



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INTRODUCTION OF THE THESIS & STATEMENT OF THE PROBLEM

Introduction:

This thesis consists of a collection of self-contained research papers within the part of credit risk and securitization. Still if they differ in focus and faculty, they have in universal that I have designed at writing thesis which has important in real-world with a helpful and relevant participation in my thesis of credit risk and securitization. These contributions are either participation to strategy discussions, new opinions and new angles to a continuing debate, accepted practices with the help of study or cleanly development of fresh models.

My thesis will be helpful for those companies which really face credit risk and do not have any model to control it. In the beginning of the writing thesis I faced a lot of problems in managing of data, but with the passage of time activities of research provided great knowledge about credit risk and securitization. This thesis will be helpful for me in future time, and it has a great importance for financial organizations. I was thinking, on basis of research on this topic, it is helpful for my job in these good organizations. I can give better performance on this job because it is my favorite area and I am specialist in it.

A brief zoology of risks

I view the risks faced by financial organizations as falling mainly into the following maximum collections:

Market risk-the risk of sudden changes in prices or rates.

Credit risk-the risk of changes in value related with sudden changes in credit quality.

Liquidity risk-the risk that the costs of adjusting financial positions will boost significantly or that a firm will lose access to financing.

Operational risk-the risk of fraud, systems failures, trading errors, and many other inside managerial risks.

Systemic risk-the risk of stop working in open market or series of result default.

Definitions of Credit risk

Credit risk is a possibility that counterparty cannot perform the fixed obligation, including a possibility that the counterparty's credit risk will be reduced, which affect earnings and capital may support of financial organizations. Credit risk is very important as it involve credit department, which is a most important operation of financial organizations, both credits that are assets and contingent liabilities of the financial organizations.

Credit risk is the risk of loss due to a counterparty defaulting on contract, or furthers normally the risk of loss suitable to some " credit event". By tradition this applied to bonds where debt holders were worried that the counterparty to whom they've made a loan might fail to pay on a payment (interest or original amount).

Credit risk start from the possible that an obligor is either unwilling to achieve on a commitment or its capability to achieve such obligation is damaged resulting in financial loss to the bank.

Credit risk is the up to date or future risk to earnings and capital happening from an obligor's breakdown to meet up the conditions of any deal with the organizations or if an obligor otherwise not succeed to perform as contracted. The biggest source of credit risk is loans. However, credit risk exists all over the additional activities of the organizations equally on and off the balance sheet.

In short, all the credit risk's definitions provide same level of conclusion that if credit risk is greater than inspective so organizations will be suffering financial loss in balance sheet.

Credit Risk:

Financial organizations and financiers face several types of risk. One of the major risks is credit risk. Over the past decade, credit risk was a most important problem existing in the financial organizations. Credit risk has been one of the most active areas of recent financial research. Credit risk consists of two components: default risk and spread risk. Default risk defines as any non-compliance with the exact arrangement of a deal and spread risk defines as decline in market value of the deal/ tool due to change in the credit quality of the debtor/ counterparty. Credit Risk Models have assumed valuable because they give the judgment creator with on the way or awareness that would not otherwise be with pleasure available or that could be marshaled at too expensive cost.

In business, almost all organizations carry some credit risk, because most organizations do not demand up-front cash payment for all products delivered and services rendered. Instead, most organizations distribute the product or service, and then bill the customer, often specifying net 30 days payment, in which payment is supposed to be complete on the 30th day after distribute. Credit risk is carried for the period of that time. In a market where margins are fast falling and the demands to lower pricing are implacable, models give their clients a competitive edge. The credit risk models are planned to aid banks in measuring, aggregating and managing risk across environmental and product lines. The results of these models also play more and more significant roles in banks' risk administration and outcome measurement methods, client profitability analysis, risk-based pricing, active collection management and capital makeup decisions.

Credit risk modeling may outcome in improved internal risk management and may have the possible to be used in the decision-making oversight of financial organizations. Credit risk analysis (finance risk analysis, loan default risk analysis) and credit risk management is essential to financial organizations which give credit to businesses and individuals. Credit can arise for different reasons: motor vehicle purchase finances bank mortgages (or home loans), credit card purchases, installment purchases, and so on.

Credit loans and finances have risk of being defaulted. To understand risk levels of credit users, credit contributors normally collect huge amount of information on borrowers. Statistical predictive analytic techniques can be used to analyze or to determine risk levels involved in credits, finances, and loans, i. e., default risk levels. (Internal) credit score is a numerical rating of <https://assignbuster.com/the-thesis-and-statement-of-the-problem-finance-essay/>

credit loans. It measures the level of risk of being defaulted. The level of default risk can be best predicted with analytical modeling. Credit scores can be measured in term of default probability or comparative geometric ratings.

Managing credit risk is valuable for any organizations, and important resources are faithful to the task by large financial organizations with many customers. For large financial organizations, there may even be a credit risk department whose job it is to assess the financial health of their customers, and expand credit (or not) accordingly. For example, a distributor selling its products to a concerned vendor may challenge to minimize credit risk by reduction payment terms to “ net 15 days”, or by actually selling less product on credit to the vendor, or even cutting off credit totally, and difficult payment in advance. These policies will possibly impact the distributor’s would-be sales, and basis smooth relationship with the vendor, but the distributor will end up better off if the vendor is delayed paying its bills, or, especially, if it failure to pay and say publicly bankruptcy.

Definitions of Securitization

Securitization a process whereby any Special Purpose Vehicle raises finances by issue of Term Finance Certificates or any other tools with the authorization of the relative authority of the country, for example, Pakistan commission (SECP) is authorization of the process for such purpose and uses such finances by making payment to the Originator and through such process obtains the title, property or right in the receivables or other assets in the form of actionable claims.

There are lots of ways to explain securitization but in core, it is the financing or re-financing of earnings yielding assets by packaging them into a trade able form through an issue of government securities or further securities.

There are three major kinds of securitization: true sale, synthetic and “ whole business” (the final largely used in the England and, to a smaller size, continental Europe). In a true sale securitization, a organization sells assets to a special purpose vehicle which finances the purchase by issuing government securities to the capital markets. In a synthetic securitization, the organization does not sell any assets, but removes the risk of loss linked with certain of its assets to a Special purpose vehicle or a bank organization against payment by such of a premium or fee to the Special purpose vehicle. “ Whole business” securitization is basically a secured loan granted by a Special purpose vehicle to the relevant organization. To contribution the loan, the Special purpose vehicle uses profits of government securities issued into the capital markets whereby the organization grants security over most of its assets in favor of the government securities holders.

Since it is important for the whole work out to be a case of transfer of receivables by the originator, not a borrowing on the security of the receivables, there is a legal transfer of the receivables to a separate entity. In legal parlance, transfer of receivables is called assignment of receivables.

It is also necessary to ensure that the transfer of receivables is respected by the legal system as a genuine transfer, and not as mere eyewash where the reality is only a mode of borrowing. In other words, the transfer of

receivables has to be a true sale of the receivables, and not merely a financing against the security of the receivables.

Securitization:

Securitization is the procedure of financing the cost of originating or carrying economic assets. Those economic assets include responsibilities of clients originated by financial organizations or such as mortgage loans credit card receivables, student loans and student loans, trade receivables, and corporate bonds and loans. Financing arises during the issuance of asset-backed securities. In an asset-backed securities securitization, financial assets which are naturally illiquid, but exchange into cash in accordance with their conditions within a definite time. Financial assets are pooled and converted into asset-backed securities (which are then typically offered and sold in the capital markets). Mortgage backed securitizations and asset backed securitizations, or more usually, the securitization of economic assets, securitization is a form of structured finance firstly developed in the early 1970's in mortgage backed securitization format. It full-grown in the late 1970's in both mortgage backed securitizations and asset-backed securitizations formats. In current years, it has reach to Europe, Latin America and Southeast Asia (mainly Japan, India). In Pakistan market of securitization growing in recent year because international body of securitization improved the regulations according to Islamic structure for Muslim countries and these regulations match with international securitization transaction.

Pakistan play lead role in Islamic securitization all over the Muslim countries.

The local controllers have usually encouraged searching and introducing
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multiple asset-backed financing formations at large. While the whole banking and non-banking financial areas are now facing troubling due to worldwide financial disorder, pointed increase can be seen on the heel of Islamic securitization during contribution by private and commercial sectors.

In its simplest form a Securitization require (1) the sale of a huge pool of Receivables by an person (Originator) that makes such Receivable in the line of its business to a “ bankruptcy-remote,” special purpose entity in a way that meet the requirements as a “ true sale” and is planned to reach definite results for accounting purposes, as well as caring the Receivables from the claims of creditors of the person (Originator), and (2) the issuance and sale by the special purpose entity, in either a private assignment or public offering, of obligation securities that are afterward fulfilled from the proceeds of and protected by the Receivables. When the Securitization is “ stopped up,” finances run from the buyers of the Securities to the Issuer and from the Issuer to the inventor (Originator).

Statement of the problem

This research aim is to take action and analyze the following questions and interviews have been performing from the companies’ officer to receive information accordingly.

What is method for control the credit risk in organizations?

The purpose of Securitization in the Corporate Sector?

The features of Securities to make its attractiveness?

Why the investors are interested to invest in Asset-Backed Securities?

Why Islamic securitization important in Muslim world?

Does securitization reduce credit risk for the financial organizations?

How the Asset-backed Securities have minimized credit risk for the financial organizations?

To understand the role of banks and credit rating agencies in the Securitization.

Determine the working of factoring for reduce the credit risk and define the benefit of factoring?

What are the future prospects of Asset Backed Securitization in Pakistan and all over world?

Define securitization costs and expense?

How credit scoring individual customer?

How can minimize credit risk through securitization?

What is the method of managing the credit risk and how to improve credit risk management?

importance of the study

The information technology and artificial results have been powerful the businesses of the worldwide economies. To deal with the different risks linked with the businesses, the businessmen have to come up with modern

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solutions and separate credit risk department and securitizations are one of them. All over the world companies face different type of risk in businesses including marketing risk, operational risk and credit risk. To deal with these risks and improved the financial position of the organization and increase the annual profit of the share holders (owners), they have to pick the positive modern solutions. If managers of the organizations want to minimize the credit risk so securitization is one of the techniques picked by the organization. In the way, organizations achieved target profits and financial position without any loss of the operating, financial and market of the organization. Study of the credit risk and securitization is allows development new models and techniques in the capital market which ultimately create new and more investment chance in the capital market which provide large number of profit to the financial organizations.

Study of the credit risk shows, at liberty Asia appeasing Credit Risk Management: 2006-2011 spend estimate and Analysis, local investments in credit risk functions for three purposeful systems, defaults chance judgment, credit collection management systems, and worldwide limits management systems are estimated to compound at a collection percentage of 16. 6 per cent annually to US\$1. 74 billion by 2011.

If organizations want to reduce credit risk so growth for successful performance of credit risk, financial organizations need to improve their IT functions for information collection and the interior rating process, categorize proper greatest practices and building ability.

Study of credit risk and securitization have very important for any organizations because credit risk accounting for at least two-thirds of their on the whole risk, the financial organizations have the leading holder for credit risk functions. According to research of credit risk controller that if organizations want to reduce credit risk so buildup credit risk departments in the organizations for control the credit risk independence and working of credit risk department that manage the securitization procedures and improved the internal rating process and fairing collection the data about customer and country political issue. Political issue plays a lead role for unsystematic credit risk.

In addition, these studies evaluate the opportunity where this idea of securitization can be effectively applied. The study not only points the current companies who have already accepted the securitization but also useful for the potential companies.

Delimitation of the study

This research was performed within the following limitations:

Only financial organizations in the first market level of the Lahore and Karachi Stock Exchange was included in this research. Joint finances were also excluded.

All the steps involved in this research process were completed within a two month period (December to February 2010-2011). This place a limit on the overall level of the study.

The Lahore and Karachi Stock Exchange is relatively new in the field of credit risk and securitization. This impacts the amount of information available for me.

CHAPTER TWO

REVIEW OF LITERATURE

AND

STUDIES

Background

Credit risk and securitization is not new team for any businessman in the capital market. A lot of the articles, books, research papers and regulations are available in internet and library. I get help from a lot of articles and books for writing a thesis of credit risk and securitization. My work is distribution into two elements: selecting articles and summarizing results. I have read 135 plus articles, books, and research papers of different authors of all over the world for clear understanding of credit risk and securitizations. My literature search starts with electronic full-text databases and Economic Papers, using searching term “ credit risk and securitization” in the title or keywords.

Literature

Credit risk occurs from the option that the issuer of an asset back securitization, generally a special purpose vehicle, may default on its liabilities. Since the special purpose vehicle is usually controlled to have no assets or business other than holding the securitized assets, the main focal point is on the cash flow from the assets themselves. The most significant

option to be considered is default by the underlying borrowers, such as the car owners in the case of automobile loan securitization. While a small but expected loan loss ratio is controllable, the rating agencies must deeply analyze the difference in default and crimes rates and calculates any factors that might activate a growth in defaults.

The growth of a possible control of credit risk and securitization market is very dependent upon the authorized and regulatory framework that is position provides sufficient security for investors. The financial organizations, investors, banks and development companies were attractive to perform the securitization for control credit risk. It is therefore, different agreement concerning the current and future receivables of the development companies have been performed through asset backed securitization in different business sectors of the country i. e. leasing sector, oil sector, construction areas, telecom sector, and public sector.

Credit risk identification

Valuable credit risk identification starts with individual credit measurement. Financial organizations should rate credit value of individual customer commonly. Some financial organizations may concern relative rating. Some rate by kind of credits or transactions. Some apply both relative rating and rating by kind of credits or transactions. Risk rating should also be practical to off-balance sheet transactions. The rating process should be transmission commonly so that adjusts in credit quality will be agreed in time. Such will help the management in revising the policy as well as closely monitor the non-performing loans within a suitable time period.

In addition to risk rating, there should be a assessment and analysis of every section and the overall selection to ensure the accepted risk rating.

Development analysis, change in risk level and weighted average risk level should be incorporated with other information such as past due trend, credit growth, and the extent of policy exception to help in the analysis of asset quality and credit risk.

The principle of valuable risk management is identifying all possible credit risks in the products and transactions through a detailed review of credit risk element in the products and transactions.

New products that can incur risk should be given much interest in the new product planning process. Close and careful monitoring should be carried out to ensure that the risks are identified and appropriately managed. Adequate guidelines and control procedures should be specified before the new products and transactions are projected or introduced. Moreover, the new products and transactions should be approved by the board of directors or other suitable committee.

Credit risk measurement

Financial organizations should have a correct and dependable system to measure credit risk of individual customer in accord with the quality, refund ability and kind of credits or businesses, equally on- and off-balance sheet credit transactions and bank account transactions. This is so that level of risk can be correctly measured, monitored and controlled. To have valuable risk measurement, financial organization should carry on as follows:

Formulate a policy and strategy in risk measurement and the impact on financial organizations.

Formulate risk measurement processes which is working in high level management which is relative to measuring credit risk.

Clear customer segmentation and regular assessment of credit application.

Assess the current level of loan loss provisioning against credit risk. That is, even when financial organizations have high level of risk; sufficient amount of provisioning can help reduce against the overall credit risk. Financial organizations should use suitable ratios to test whether the level of loan loss provisioning is practical. Ratio analysis will make known the trend of relationship between loan loss provision with different factors such as non-performing assets and normal loans pass due loans, and stop increased debts, credits and contingent liabilities.

Credit risk Monitoring and controlling

For reducing credit risk on account of such off balance sheet contacts, financial organizations may accept a multiplicity of measures some of which are showed below:

Financial organization must make sure that the security, which is obtainable to the funded lines, also covers the latter of credit lines and the guarantee facilities. On some events, it will be suitable to take a charge over the fixed assets as well, particularly in the case of long-term guarantees.

In the case of guarantees covering agreement, financial organization must make sure that the regulars have the necessary technical skills and experience to perform the agreements. The value of the agreements must be definite on a case-by-case basis, and break up limits should be set up for every one agreement. The growth about physical and economic displays should be monitored on a regular basis, and any slippages should be highlighted in the credit review.

The policy to authorize non-finance facilities with an observation to increase earnings should be suitably balanced about the risk concerned and comprehensive only after a careful assessment of credit risk is undertaken.

Feature of Securitization

A securitized tool, as compared to a direct maintain on the issuer, will normally have the following features:

Marketability

The very important principle of securitization is to make sure marketability to economic claims. Hence, the tool is prepared so as to be marketable. This is one of the most important features of a securitized device, and the others that follow are mostly significant only to make sure this one. The conception of marketability involves two hypothesizes:

- (a) The authorized and general option of marketing the instrument;
- (b) The reality of a market for the instrument.

Securitization is a misleading notion unless the securitized product is marketable. The very reason of securitization will be defeated if the device is full on to a few expert investors without any chance of having a liquid market therein. Liquidity to a securitized device is given either by launching it into an organized market or by one or more agencies acting as market makers in it, that is, approving to buy and sell the tool at either fixed or market-determined prices.

Merchantable Quality

To be market-tolerable, a securitized product has to have a merchantable quality in capital market. The idea of merchantable quality in case of physical produce is something which is suitable to merchants in regular trade.

When applied to economic products, it would mean the economic obligations embodied in the tools are secured to the investors' approval. "To the investors' approval" is a qualified term, and therefore, the originator of the securitized device secures the device based on the needs of the investors. The universal rule is: the broader the base of the investors, the less is the investors' ability to attract the risk, and hence, the more the need to securities.

For generally distributed securitized tools, estimation of the quality, and its qualifications by an independent expert. The rating provides for the advantage of the position investor, who is otherwise not projected to be in a position to review the degree of risk involved.

In securitization of receivables, the idea of quality experience drastic change making rating is a general requirement for securitizations. Hence, the quality of the maintain of the debtors believes significance, which at times enables to investors to rely simply on the credit-rating of debtors and so, create the device totally independent of the originators' personal rating.

Wide distribution

The necessary principle of securitization is to distribute the product. The level of distribution which the originator would like to realize is based on a relative analysis of the costs and the benefits achieved thereby. Wider distribution guides to a cost-benefit in the common sense that the issuer is able to market the product with minor return, and hence, minor financial cost to him. But wide investor base involves costs of distribution and servicing. In observe, securitization issues are still hard for retail investors to recognize. Hence, most securitizations have been secretly placed with expert investors. However, it is possible that in to come, retail investors could be involved into securitized products.

Special purpose vehicle

In case the securitization needs any asset or claim which needs to be included and separate, that is, unless it is a shortest and unsecured claim on the issuer, the issuer will want an agent agency to act as a storage area of the asset or claim which is being securitized. Let us take the easiest example of a secured debenture, in concentrate, a secured loan from some investors.

Here, security charge over the issuer's some assets needs to be incorporated, and later broken down into marketable lots. For this purpose,

the issuer will bring in an agent agency whose necessary job is to hold the <https://assignbuster.com/the-thesis-and-statement-of-the-problem-finance-essay/>

security charge on behalf of the investors, and then issue documentations to the investors of valuable interest in the charge held by the intermediary. So, whereas the charge continues to be held by the intermediary, valuable interest therein becomes a marketable security.

The same process is concerned in securitization of receivables, where the special purpose agent holds the receivables with it, and issues valuable interest documentation to the investors.

Assets that can be securitized

In essence, all assets which produce a cash flow can be securitized e. g. housing loans mortgage loans, credit card receivables, automobile loans, consumer loans, trade receivables, lease finance, etc. a perfectly and usual financial asset is usually securitized. A difference is generally made between asset securitization and mortgage securitization. Asset securitization is sheltered from a pool of loans and receivables though the mortgage backed securities are sheltered by residential or commercial mortgage loans however mortgage backed securities is a particular kind of asset backed securities.

Process of securitization

The process of creating asset backed securities is talk about in the following points:

The Company sells its products and services on credit and this becomes the trade receivables or account receivables in the balance sheet of the company.

Out of these receivables, the originator pools definite receivables jointly on the base of maturity and risk structures and sells these to a securitization company identified as Special Purpose Vehicle or Special Purpose Entity.

The securitization company makes payment to the originator for the receivables purchased.

These receivables are improved into a pool of securities by the securitization company for the reason of issuing Pass Through or Pay through Certificates.

These Pay Through or Pass through Certificates are then charged by Credit Rating Agencies e. g. Pakistan Credit Rating Agencies (PACRA).

The Pay Through or Pass through Certificates are sold to individual investors or Qualified Institutional Buyers.

The gathering of receivables from debtors is obtained by Company itself in case of Pass through Certificates and by Securitization Company in case of Pay through Certificates. If gathering is made by the Company then it is under commitment to pass on the money to the securitization company.

The securitization company after that makes payment to the investors.

Why do issuers need securitization?

These explanations the investors favor to invest in asset-backed securities:

Securitization makes tools with reverse maturities, risks, vouchers, which is attractive to investors. Securitization is a prepared financial device i. e.

customized to the risk-return and maturity needs of investors, rather than a trouble-free claim against an entity or asset.

Asset-Backed Securitization offers and defer higher than devices with similar risk. This is appropriate to the credit value of the tools (generally AAA rated) and the credit development features.

Asset-Backed Securitization offers a expected cash-flow. Investors purchase Asset-Backed Securities with self-belief that payments will take place at particular dates in the future.

Asset-Backed Securities are protected by the fundamental assets; therefore they offer important security against lower by rating agencies to the issuer.

It gives a chance to the investors to spread their investment collection by investing in these asset backed securities.

Impact of securitization on the capital market

The impact of securitization on capital market can be analyzed in the following points:

Securitization decreases transaction costs in the capital market by generating a market for financial claims, which otherwise, would have continued illiquid, i. e. limited trading.

Securitization saves intermediation costs, since the particular intermediary costs are service associated and usually lower. Securitization supports saving since it offers a security to investors with guaranteed interest or

payments and an assertion of credit quality and security nets in the variety of trustee