Aspects regarding Securitization as a Financing Technique

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Abstract

In view of the vast developments that have occurred in financial markets, the importance in developing a comprehensive capital framework for asset securitization is known especially in Europe and United States of America. The stronger economic growth, the improved employment situation, the continued housing sector strength and the associated credit expansion are supportive of both rising issuance volumes and credit quality. Securitization is one of the most important innovations of finance. The concept of securitization is in the first stage Romania. With the boom in real estate development across the regions, securitization of mortgaged assets should further deepen the real estate market and bring additional liquidity.

Key words: securitization, securities, mortgage, assets

Securitization – Concept and Types

Securitization is a financing technique that involves the conversion of illiquid assets with predictable cash flows into marketable securities. Securitization implies the issue of securities backed by pools of assets. An other definition is the one from the Oxford economic dictionary: “an operation that requires the act of selling a pool of assets to an “issuer”, known as a special purpose vehicle (“SPV”)”. Specific to this operation is the fact that the assets are removed from the seller's balance sheet. This is why the procedure is known as an “off balance sheet finance”.

The asset securitization market developed in the USA in the early 1980s, the start point being the securitization of home loans by the Government National Mortgage Association and the Federal Home Loan Mortgage Corporation. In present, other forms of financial assets have been used as backing for securitization issues. The securitization program is successful if the assets to be securitized are all similar and have two attributes:

- generate stable cash flows - both of income and of principal - which can be readily forecast and which can be used to service the obligations of the bonds being issued under the securitization program;
- present a low level of risk, in order to minimize the chance of loss for the investors in the bonds.
A typical securitization transaction consists of the following steps: (I) sale of the financial assets by the originator or holder of the assets to the special purpose vehicle, which will hold the assets and realize the securitization; (II) issuance of securities by the SPV, to investors, against the financial assets held by it.

Asset Backed Securitization (ABS) means the securitization of credits, for example, in the form of trade receivables, car loans, lease receivables, corporate credits, securities, or other futures cash flows like account, health care, insurance, utility and other receivables. Mortgage Backed Securities (MBS) are similar in concept, but the credits securitized are generally secured by a mortgage on real estate, which can be commercial properties (Commercial MBS - CMBS) or residential (Residential MBS - RMBS). The transactions with MBS are important because the number of loans that make the object of securitizations can reach ten of thousands. In addition to the classic securitization forms described above, specialized forms of securitization have developed, for example, the securitization of bank credits or bond portfolios (Collateralized Loan Obligation - CLO, Collateralized Bond Obligation - CBO, collectively Collateralized Debt Obligations - CDOs). In these forms the assets are not sold to an SPV but remain on the balance sheet of the originator. The credit risk on the underlying portfolio is transferred to third parties through credit derivatives, guaranties or collateralization using cash of securities or otherwise (the so-called synthetic structures). CDOs, including funded cash and synthetic deals, were the fastest growing product sector.

A new form known as CSO’s (Collateralized Swap Obligations) is CDOs backed primarily by swap contracts. On January 17, 2006, CDS Indexco and Markit launched ABX.HE, a synthetic asset-backed credit derivative index, with plans to extend the index to other underlying asset types other than home equity loans. ABS indices allow investors to gain broad exposure to the sub prime market without holding the actual asset-backed securities.

![Fig. 1. Types of Asset Backed Securities](image-url)

Asset-backed securitization (ABS) has become a viable and increasingly attractive risk management and refinancing method either as a standalone form of structured finance or as securitized debt in Collateralized Debt Obligations (CDO).

For 2006, as it is related in a report of European Securitization Forum, the issuance of the securities in Europe grew with 32.3 percent to the total amount of 458.9 billion euro. This was a new record that surpassed the previous one of 327 billion issued in 2005. Issuance in the fourth
quarter also established a quarter records with 177.1 billion. This was the strongest issuance quarter. For 2007 the forecast of the European issuance is somewhere near 531 billion euros and the principal actors will still be RMBS, CMBS and CDO’s as leading growth collateral sectors.

Table 1. Issuance by types of asset backed securities for Europe – billion euro

<table>
<thead>
<tr>
<th>Type of ABS</th>
<th>2006</th>
<th>2005</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>RMBS</td>
<td>244.6</td>
<td>144.9</td>
<td>68.8%</td>
</tr>
<tr>
<td>CMBS</td>
<td>60.1</td>
<td>38.6</td>
<td>55.7%</td>
</tr>
<tr>
<td>CDOs</td>
<td>88.0</td>
<td>48.9</td>
<td>80.0%</td>
</tr>
<tr>
<td>Auto</td>
<td>11.7</td>
<td>4.1</td>
<td>180.5%</td>
</tr>
<tr>
<td>Loans</td>
<td>15.7</td>
<td>4.9</td>
<td>-66.5%</td>
</tr>
<tr>
<td>Credit cards</td>
<td>3.4</td>
<td>11.7</td>
<td>-70.9%</td>
</tr>
<tr>
<td>Receivables</td>
<td>6.0</td>
<td>4.0</td>
<td>50.0%</td>
</tr>
<tr>
<td>Others</td>
<td>2.9</td>
<td>27.9</td>
<td>3.6%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>458.9</td>
<td>327.0</td>
<td>40.3%</td>
</tr>
</tbody>
</table>

Source: www.securitisation.ro

Fig. 2. The mechanism of securitization

Major Players in Securitization

In securitization, many players are involved.

*Originator/Seller* - the entity that generates receivables in the ordinary course of its business, or purchases and assembles portfolios of receivables (in that sense, he is not a true "originator"). A bank or other financial entity is implied in the advisory process of originator. This financial adviser works closely with counsel of the rating agencies in structuring the transaction and preparing documents and usually gives the most significant opinions. The most important thing is that the originator can’t become the object of the appeal if the SPV does not have enough founds to pay his debts (interests and repayments).
**Issuer** - the special purpose vehicle/entity (SPV), usually an owner trust created in consequence of a trust agreement between the originator and the manager, which issues the securities. His main function is to issue the ABS. From an accountancy point of view, in the active part, it has the portfolio of assets and, in the other part, we find the securities issued. It is created as a fund or a company. Securitization vehicles can be set up as corporate entities or as fund vehicles as well as single or multilayer vehicles.

Securitization funds are not legal entities. They are organized as a pool of assets and they are administered by a management company. Securitization funds made up of one or several fiduciary estates are subject to trust and fiduciary contract law. Securitization companies must take the form of a public limited company, a partnership limited by shares, a private limited liability company or a cooperative company organized as a public limited company. In Luxembourg mercerization vehicles benefit from tax neutrality due to their pure intermediary function as a pool of assets.

**Manager** - usually a bank or other entity authorized to act in such capacity. The manager, holds the receivables, receives payments on the receivables and makes payments to the security holders. Monthly, it has the obligation to place an information about the securities.

**Investors** – The SPV has no money of its own. To be able to buy the loans from the originator, it issues tradable "securities" to fund the purchase. The performance of these securities is directly linked to the performance of the assets. The investors are the ultimate buyer of the securities. They are especially institutional investors as banks, insurance companies, retirement funds and other qualified investors. In some cases, the securities are purchased directly from the issuer, but more commonly the securities are issued to the originator or intermediate SPV and then sold to the investors. Securitization protects the investor against all claims of the originator even in case of bankruptcy. In recent years, individual investors have also become increasingly active in the mortgage securities market, largely as a result of the attractive yields, relative credit-worthiness and diversity of available securities.

**Agent** - an entity, that stand for the interests of the investors that sees if the issuance is conformably to the law in that country and notifies the entities in charge if something illegal happens during the process. It has the obligatory to issue a certificate that proves the law is respected. A trustee may be included in a securitization structure at the investors’ request or as a consequence of the management rules of the vehicle. The powers of the trustee are defined by the investors or by the securitization vehicle, depending on the issues raised.

**Rating Agencies** - Moody’s, Standard&Poor’s, Fitch IBCA and Duff & Phelps. In securitizations, the rating agencies frequently are active players that enter the game early and assist in structuring the transaction. In many instances they require structural changes, dictate some of the required opinions and mandate changes in servicing procedures. The agency gives a rating to the securities issued. We have here 3 possibilities: Senior, Mezzanine and Junior or Equity. The last type is hold by the originator, fact that will reduce portfolio quality.

**Servicer** - the entity that actually deals with the receivables daily, collecting the receivables and transferring funds to accounts controlled by the trustees. In most transactions the originator acts as servicer.

**Credit Enhancement**

While the primary source of repayment of a loan or securities in a securitization is the cash flow associated with the securitized assets, many transaction structures include one or more types of additional credit support, called credit enhancement.

The placement of ABS with investors generally requires giving investors adequate protection against risk of default to eliminate the need for them to monitor collateral directly. Amount of credit enhancement needed depends on several factors, including rating agencies’ views of the
historical performance of the assets, the degree of diversification across obligors, industries, etc. and the structure of the transaction.

They are intended to reduce the risks to the investors and thereby increase the rating of the securities and lower the costs to the seller.

Two basic categories of credit enhancement:

- **internal**: over-collateralization, recourse arrangements, senior-subordinated structures;
- **external**: irrevocable letters of credit or financial guaranty insurance from third parties with triple-A credit ratings. Rating agencies assume that the credit quality of the securitization cannot be higher than that of the weakest link in its enhancement package. Thus, with external credit enhancements, the rating of the senior securities in an ABS issue is typically capped at the rating level of the third-party guarantor, regardless of the quality of the collateral.

Examples of credit enhancement include reserve accounts; subordination of junior classes of securities to senior classes of securities; interest rate protection arrangements; and insurance policies or surety bonds issued by a monoline insurer. A transaction structure will employ this characteristic in order to increase the probability that the principal and interest of the loan or securities will be repaid in a timely way even if the cash flow on the securitized assets is insufficient to pay such amounts. Credit enhancement may also contribute to the rating of a transaction, allowing it to achieve a higher rating than it otherwise would receive without the credit enhancement.

A reserve account is a typical feature of many deals in both the term and storehouse areas. A reserve account will generally be established when a deal closes. To the extent a shortfall in cash flow occurs during the life of the transaction, amounts will be withdrawn from the reserve account to cover that shortfall. The amounts will be supplied with future cash flows so that the total amount on the deposit is equal to the required level. In addition, in many transactions, an insurer provides an insurance policy which guarantees payment of principal and interest to the debt holders in the event that cash flow is insufficient to make such payments. In a senior/subordinated structure, the subordinated class of securities will absorb losses on the assets prior to the senior class. Credit enhancements are required in every securitization. The nature and amount depends on the risks of the securitization as determined by the rating agencies and investors.

**Securitization in Romania**

In Romania this process is just at the beginning. The first steps have been done last year, by defining the basic legal framework: law 31/ March 2006, law 32/ March 2006. The normative acts cover only the securitization of mortgage credit, but because MBS are the most important form of securities this is to be considered as a big step for the development of the securities market.

Why should we consider securitization one step ahead for the Romanian mortgage market?

- because it offers the necessary conditions for the development of new financial instruments that can improve the investments in the specified market;
- because it minimizes the blockings of the future cash-flows because of the liquidity storage;
- because creditors can transform their illiquid assets into immediate liquidity (marketable instruments) and can ensure the improvement of the risk management;
- because securities are new negotiable instruments with a big growth potential of the transactions. This can reach the diversification of the investments.
The first securitization is expected for 2007 as Commercial Bank of Romania and Development and Reconstruction Bank of Romania envisaged last year their willing to use the mortgage credits for securitization. However, there are still issues to be clarified, as those concerning the fiscal proceedings and the audit procedure, areas that were not taken into consideration until now.

The statistics from, for example, Europe ABS market prove that securitization is a growing process and one of the most important financial innovations. This is why Romania tries to find the middle way between benefits and risks of this process.

Conclusions

Securitization is an alternative form of funding for companies. The companies have different ways company to obtain financial resources by issuing bonds, shares or commercial paper or by applying to a bank for a credit facility. Through securitization, the companies have the possibility of diversifying their funding. In addition, it is a quick, flexible and cheaper way for them to obtain access to the financial market in the best possible terms. In Romania this process is just at the beginning, but the first steps are done by setting up the legal framework for issue of mortgage bonds.

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Aspecte privind securitizarea ca formă de finanțare

Rezumat

În acest articol am realizat analiza securitizării ca tehnică de finanțare. Prin această metodă, firmele au posibilitatea de a-și diversifica sursele de finanțare, securitizarea fiind uneori o metodă mai flexibilă și mai ieftină decât metodele tradiționale de finanțare prin emisiune de acțiuni sau obligațiuni. Această metodă de finanțare nu este încă utilizată în România, însă primii pași au fost făcuți prin crearea cadrului legal. Principalele bănci comerciale din România și-au anunțat deja intenția de a se finanța prin această metodă.