Quadrant II – Notes

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Meaning of Securitisation

Securitization is a financial arrangement that consists of issuing securities that are backed by a pool of assets, in most cases debt. The underlying assets are "transformed" into securities, hence the expression "securitization." The holder of the security receives income from the products of the underlying assets, and this has given rise to the generic term ABS (Asset-Backed Securities).

The advantages of Securitization

For the seller

For the originator, the main reason for securitizing is to reduce (some might say "get rid of") the amount of assigned debt from his balance sheet, which on the one hand leads to a corresponding reduction in his regulatory capital requirements under Basel II, and on the other hand enables him to bring in additional liquidity (which can be used to make new loans).

For the investor

ABS present an opportunity to invest in asset classes that are not accessible in the markets and that offer a risk/return profile that is, in principle, attractive.

For the market

In principle, securitization helps to spread out risk within the market, so that the risk is no longer concentrated solely in the hands of credit agencies.

Drawbacks of Securitization

With the subprime mortgage crisis and the ensuing crisis of confidence, the securitization market is losing steam, and certain segments, particularly those concerning the most complex products, have come to a complete standstill.

Information asymmetry

In reality, the complexity of the different types of securities is a disadvantage because it leads to what is known as "information asymmetry." In other words, the issuer of the securities knows much more about what he is selling than the buyer (investor) does. As long as the securities issued behave as indicated in the brochure, all is well and nobody asks any questions. But as soon as problems begin to arise for certain types of securities, people become suspicious of any product falling within that category – since you need to be an expert to be able to evaluate a securitization program –and suddenly nobody wants to buy them anymore.

Moral hazard

Moreover, securitization, as we have seen, offers banks an opportunity to trim their balance sheets, which makes it easier for them to fulfil their regulatory obligations. They have jumped at the opportunity. At the same time, they have veered away from their basic function, the cornerstone of which is to accurately assess credit risk. With the extension of credit becoming increasingly easy, credit agencies have become less stringent about the quality of the final borrowers. This is referred to as a "moral hazard." The banks have moved away from their role of financing the economy, seeking instead to assume (fortunately, not completely) a purely intermediary role in an economy that seems to have become completely "marketized." Today, the situation is reaching its limits.

Parties to Asset Securitisation

Originators — the parties, such as mortgage lenders and banks that initially create the assets to be securitized.

Depositor — creates the SPV/SPE for the securitized transaction. The Depositor acquires the pooled assets from the Aggregator and in turn, deposits them into the SPV/SPE.

Issuer — acquires the pooled assets and issues the certificates to eventually be sold to the investors. However, the Issuer does not directly offer the certificates for sale to the investors. Instead, the Issuer conveys the certificate to the Depositor in exchange for the pooled assets. In simplified forms of securitization, the Issuer is the SPV which finally holds the pooled assets and acts as a conduit for the cash flows of the pooled assets.

Underwriter — usually an investment bank, purchases all of the SPV's certificates from the Depositor with the responsibility of offering them for sale to the ultimate investors. The money paid by the Underwriter to the depositor is then transferred from the depositor to the Aggregator to the Originator as the purchase price for the pooled assets.

Investors — purchase the SPV's issued certificates. Each Investor is entitled to receive monthly payments of principal and interest from the SPV. The order of priority of payment to each investor, the interest rate to be paid to each investor and other payment rights accorded to each investor, including the speed of principal repayment, depending on which class or tranche of certificates was purchased. The SPV makes distributions to the Investors from the cash flows of the pooled assets.

Trustee — the party appointed to oversee the issuing SPV and protect the Investors' interests by calculating the cash flows from the pooled assets and by remitting the SPV's net revenues to the Investors as returns.

Servicer — the party that collects the money due from the borrowers under each loan in the asset pool. The Servicer remits the collected funds to the Trustee for distribution to the Investors. Servicers are entitled to collect fees for servicing the pooled loans. Consequently, some Originators desire to retain the pool's servicing rights to both realize the full payment on their securitized assets when sold and to have a residual income on those same loans through the entitlement to ongoing servicing fees. Some Originators will contract with other organizations to perform the servicing function, or sell the valuable servicing rights.

Securitisation Process

The entire process can be summarised as follows –

1. Lender sells various types of loans to borrowers
2. Out of these loans, he packs certain loans together and sells these to Asset Reconstruction Company
3. The Special Purpose Vehicle (SPV) / Asset Reconstruction Company (ARC) makes payment to the original lender for loans purchased
4. These loans are converted into a pool of securities by the Asset Reconstruction Company for purpose of issuing Pass Through or Pay Through Certificates (PTC).
5. These PTCs are sold to individual investors [QBs].
6. The recoveries from the original borrower are obtained by the original lender (in case of Pass Through Certificates) and by Asset Reconstruction Company (in case of Pay Through Certificates).
7. If collection is made by the original borrower, he is under obligation to pass on the money to Asset Reconstruction Company.
8. The SPV / ARC passes on these amounts to individual investors.

To learn more about Asset Securitisation

follow this link

https://www.taxmann.com/post/blog/what-is-securitisation-accounting-purpose-process-and-its-working/#9999