Securitization

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Introduction

Traditionally banks/FIs took deposit and gave loans (→ their assets structure changes due to default risk; and it puts continuous demand on the banks capital)

- Securitization is creation of securities
- out of a pool of assets/receivables
- Group of loans with similar terms (interest rate, maturity, borrower type) are pooled together
- To issue new class of securities (with the above pooled claims)
- What are intermediary gains?
- What are investors gains?

Securitization Gains

- Intermediary gains by – charging servicing fees, shifting default risk, and frees up additional capital to make new loans/opportunities
- Investors gain by – getting high yields; high liquidity; multi-risk profile; and small-sized instruments
- Examples – home mortgage loans, automobiles, credit card, commercial real estate, lease obligations, rock shows, hollywood films, cricket live TV telecast revenues
- Securitization is a blend of two forces: structured financing and capital markets

Why Securitization?

- Securitization creates assets with less risk and greater liquidity, hence a lower cost of financing
- But can the higher quality be achieved without a commensurate decrease in the quality of the remainder of the company?
- Yes??
- Reason: When a company faces uncertainties, investors demand a premium. But investors concerns about receivables can be dispelled at far lower cost that other concerns about the company and its overall performance

… Securitization

- Securitization is a method of funding receivables
- It involves bearer asset backed securities
- Which can be freely traded (and normally rated)
- Secured on a portfolio of receivables
- Needs creation of a SPV, transfer of receivables to the same
- SPV arranges for credit enhancement and issues rated debt
- Originator identifies portfolio → bankruptcy remote SPV → true sale (transfer) of receivables to SPV → administration of assets is sub-contracted to originator → SPV issues tradable securities to fund purchase of assets → investors buy these Pass Through Certificates OR Pay Through Certificates (senior notes/junior notes/floating rate notes)

Introduction

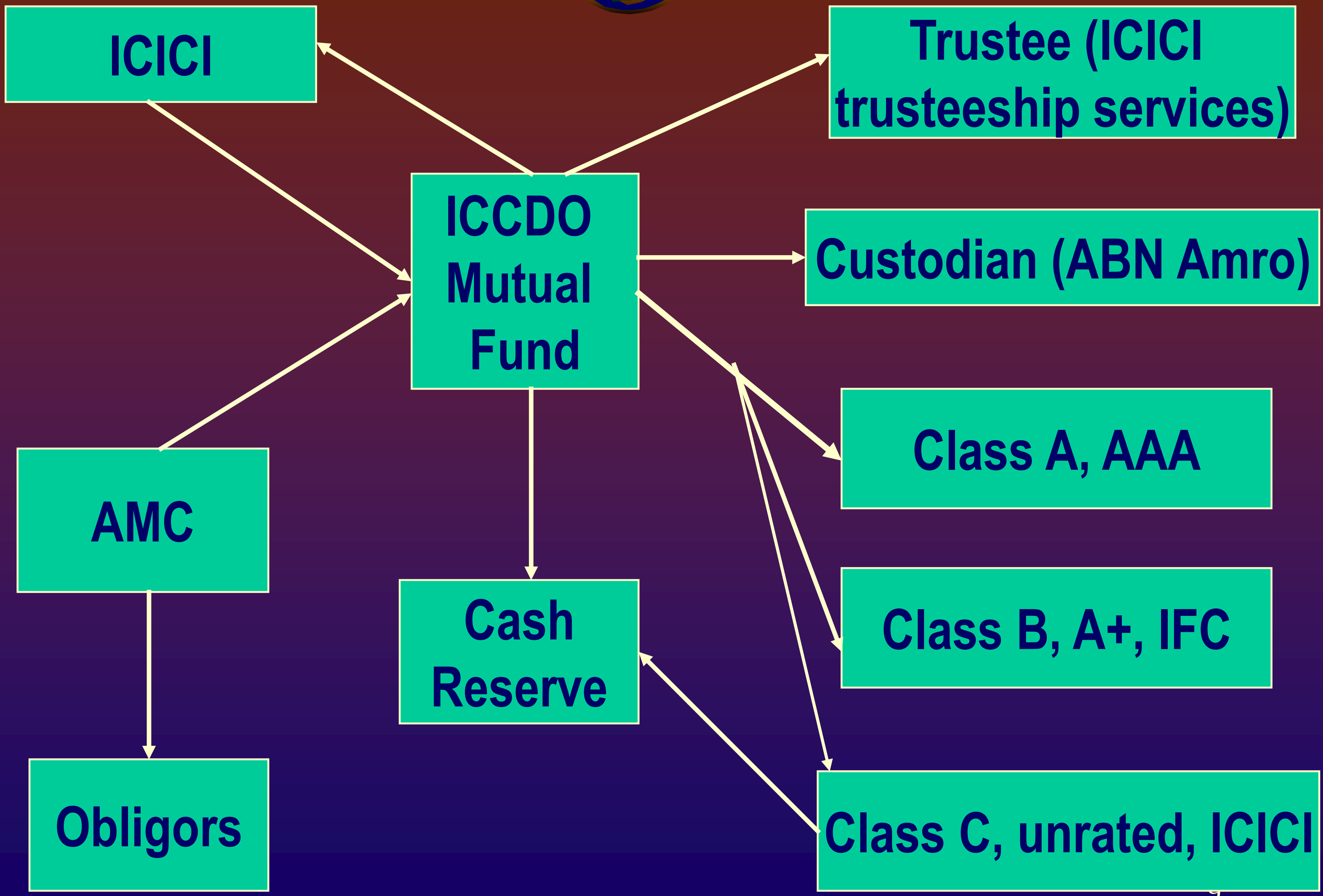
- Securitization is a process of commoditisation
- Securitization is a process of integration and differentiation
- Securitization is a process of de-construction of an entity
- Securitized assets could be existing receivables or receivables to arise in future → Asset-backed securitization and future flows securitization

Potential Benefit for Corporations

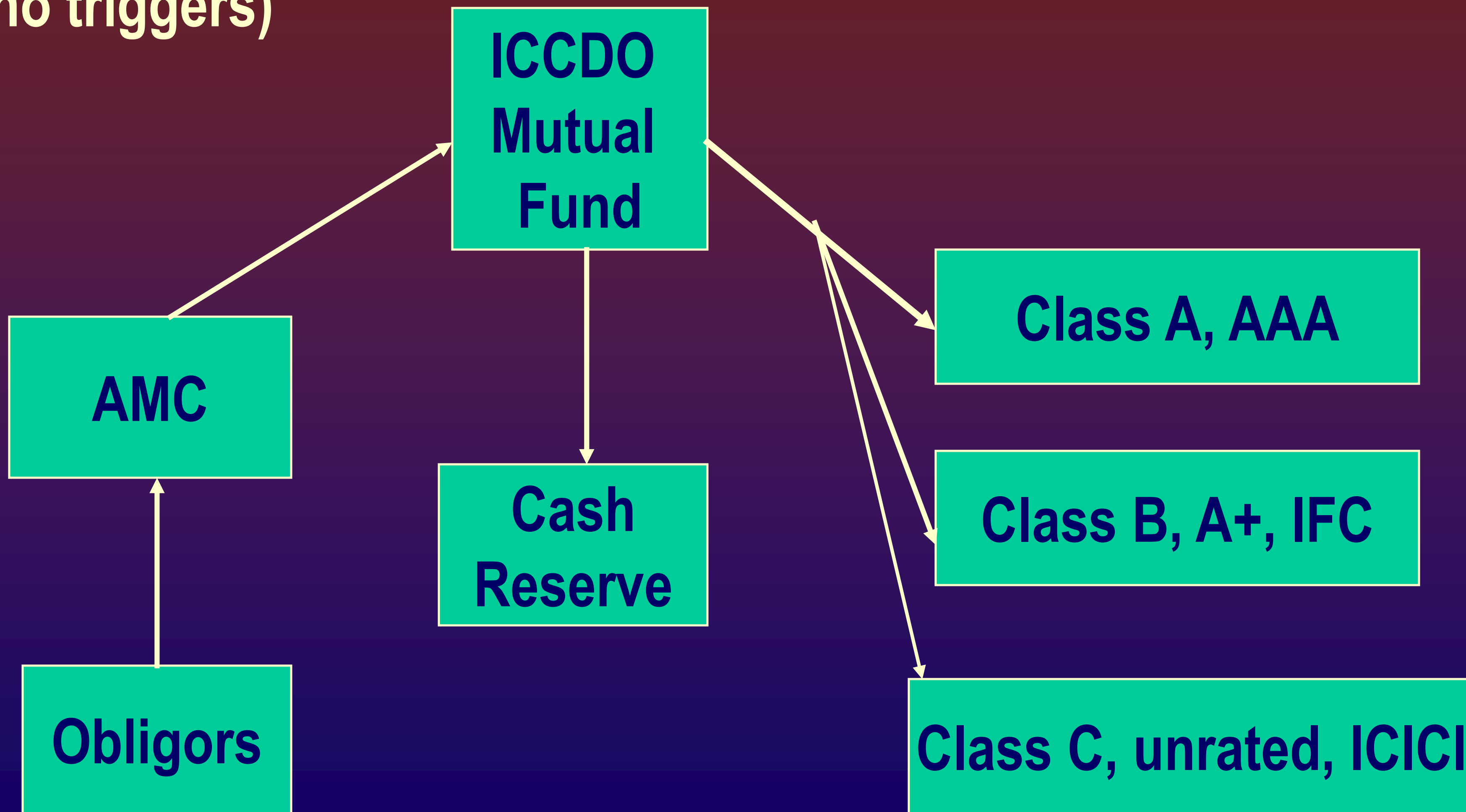
- Removes assets from the balance sheet
- Lower cost of financing
- Retains competitive advantage
- Nondisclosure
- Recognition of gains (or losses)
- Improves asset/liability management
- But: it is more complex, and there are up-front costs

Indian Corporate CDO Fund

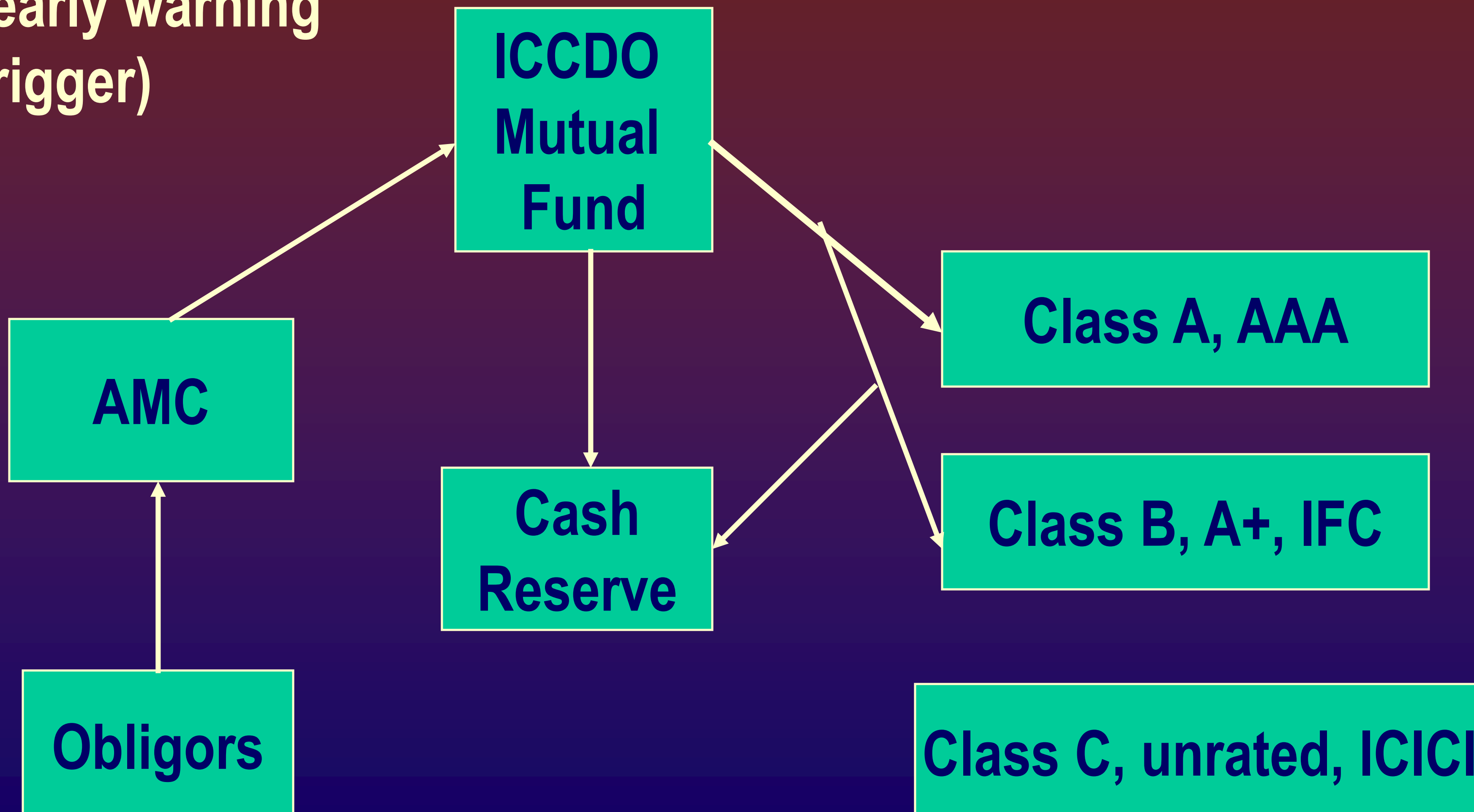
- After merger, ICICI needs to meet tough banking norms
- It is a balance sheet CDO consisting of a pool of bonds, PTCs held by ICICI
- ICICI plans Rs. 502 crore securtisation product structured as a mutual fund scheme
- SPV – ICICI Securities Fund
- A pool of debentures and loans of ICICI originating from 19 accounts would be sold to the MF
- MF will avoid any withholding tax to obligor, no tax on SPV, only 10% dividend tax on distribution, no tax on unit holders
- Taxable income becomes tax free, originator may hold the repackaged portfolio, 28% tax shelter,


ICICI
Trustee (ICICI trusteeship services)
ICCDO Mutual Fund
Custodian (ABN Amro)
Class A, AAA
AMC
Class B, A+, IFC
Cash Reserve
Obligors
Class C, unrated, ICICI

Deal structure during term (no triggers)



Deal structure during term (early warning trigger)



Indian Corporate CDO Fund

- Fund would issue units with Face Value of Rs. 50 lakhs to QIB's, Period – 2 years, Maturity 6.5 years
- Three tranches: Class A (374 crores – senior debt), Class B (59 crores), and Class C (70 crores)
- Cash collateral of 2% immediately (up to 4% before class C is paid) → Early warning trigger → class C is recipient of all residual cash flows = economic equity
- to improve liquidity get listed in NSE/BSE
- units to be sold through Book Building Route
- Regulatory considerations – independence of SPV, trustee, AMC (all are affiliates)
- On whom is the investors exposure? Valuation of paper?

Asset-Backed Securities

- ABS are complex and expensive to structure. Hence in a perfect market with no informational efficiencies, no need for ABS
- Use of ABS may make sense when there are

- Subsidies, guarantees, or regulatory incentives

- Information-based value added (information about a company's receivables is improved; specialization in risk-bearing is achieved; has positive signaling effect)

Asset-Backed Securitization

- Asset-backed securities can create value for investors and issuers if:
- The assets are for some reason worth more *off* the balance sheet than *on*
- The right legal framework is in place
- The costs do not exceed the benefits
- Sometimes they do not work… because you cannot make money by cutting up a dog