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Securitization a Primer

Securitisation - a primer

Basic meaning of securitisation:

"Securitisation" in its widest sense implies every such process which converts a financial relation into a transaction.

History of evolution of finance, and corporate law, the latter being supportive for the former, is replete with instances where relations have been converted into transactions. In fact, this was the earliest, and by far unequalled, contribution of corporate law to the world of finance, viz., the ordinary share, which implies piecemeal ownership of the company. Ownership of a company is a relation, packaged as a transaction by the creation of the ordinary share. This earliest instance of securitisation was so instrumental in the growth of the corporate form of doing business, and hence, industrialisation, that someone rated the it as one of the two greatest inventions of the 19th century -the other one being the steam engine. That truly reflects the significance of the ordinary share, and if the same idea is extended, to the very concept of securitisation: it as important to the world of finance as motive power is to industry.

Other instances of securitisation of relationships are commercial paper, which securitises a trade debt.

Asset securitisation:

However, in the sense in which the term is used in present day capital market activity, **securitisation** has acquired a typical meaning of its own, which is at times, for the sake of distinction, called **asset securitisation**. It is taken to mean a device of structured financing where an entity seeks to pool together its interest in identifiable cash flows over time, transfer the same to investors either with or without the support of further collaterals, and thereby achieve the purpose of financing. Though the end-result of securitisation is financing, but it is not "financing" as such, since the entity securitising its assets it not borrowing money, but selling a stream of cash flows that was otherwise to accrue to it.

The simplest way to understand the concept of securitisation is to take an example. Let us say, I want to own a car to run it for hire. I could take a loan with which I could buy the car. The loan is my obligation and the car is my asset, and both are affected by my other assets and other obligations. This is the case of simple financing.

On the other hand, if I were to analytically envisage the car, my asset in the instant case, as claim to value over a period of time, that is, ability to generate a series of hire rentals over a period of time, I might sell a part of the cash flow by way of hire rentals for a stipulated time and thereby raise enough money to buy the car. The investor is happier now, because he has a claim for a cash flow which is not affected by my other obligations; I am happier because I have the cake and eat it also, and also because the obligation to repay the financier is taken care of by the cash flows from the car itself.

Blend of financial engineering and capital markets:

Thus, the present-day meaning of securitisation is a blend of two forces that are critical in today's world of finance: structured finance and capital markets. Securitisation leads to structured finance as the resulting security is not a generic risk in entity that securitises its assets but in specific assets or cash flows of such entity. Two, the idea of securitisation is to create a capital market product - that is, it results into creation of a "security" which is a marketable product.

This meaning of securitisation can be expressed in various dramatic words:

Securitisation is the process of commoditisation. The basic idea is to take the outcome of this process into the market, the capital market. Thus, the result of every securitisation process, whatever might be the area to which it is applied, is to create certain instruments which can be placed in the market.

- **Securitisation is the process of integration and differentiation**. The entity that securitises its assets first pools them together into a common hotchpot (assuming it is not one asset but several assets, as is normally the case). This the process of integration. Then, the pool itself is broken into instruments of fixed denomination. This is the process of differentiation.

Securitisation is the process of de-construction of an entity. If one envisages an entity's assets as being composed of claims to various cash flows, the process of securitisation would split apart these cash flows into different buckets, classify them, and sell these classified parts to different investors as per their needs. Thus, securitisation breaks the entity into various sub-sets.

We will return to this specific, present-day meaning of securitisation. However, let us go back to the generic meaning of the term - that is, converting an asset or a relationship into a security, a commodity.

Meaning of security:

Very understandably, further developments in this area will continue to take place. More financial relations of today will in time to come be converted into and be transferable as "securities".

In connection with securitisation, the word "security" does not mean what it traditionally might have meant under corporate laws or commerce: a secured instrument. The word "security" here means a financial claim which is generally manifested in form of a document, its essential feature being marketability. To ensure marketability, the instrument must have general acceptability as a store of value. Hence, it is generally either rated by credit rating agencies, or it is secured by charge over substantial assets. Further, to ensure liquidity, the instrument is generally made in homogenous lots.

Need for securitisation:

The generic need for securitisation is as old as that for organised financial markets. From the distinction between a financial relation and a financial transaction earlier, we understand that a relation invariably needs the coming together and remaining together of two entities. Not that the two entities would necessarily come together of their own, or directly. They might involve a number of financial intermediaries in the process, but nevertheless, a relation involves a fixity over a certain time. Generally, financial relations are created to back another financial relation, such as a loan being taken to acquire an asset, and in that case, the needed fixed period of the relation hinges on the other which it seeks to back-up.

Financial markets developed in response to the need to involve a large number of investors in the market place. As the number of investors keeps on increasing, the average size per investors keeps on coming down -this is a simple rule of the marketplace, because growing size means involvement of a wider base of investors. The small investor is not a professional investor: he is not as such in the business of investments. Hence, he needs an instrument which is easier to understand, and is liquid. These two needs set the stage for evolution of financial instruments which would convert financial claims into liquid, easy to understand and homogenous products, at times carrying certified quality labels (credit-ratings or security) , which would be available in small denominations to suit every one's purse. Thus, securitisation in a generic sense is basic to the world of finance, and it is a truism to say that securitisation envelopes the entire range of financial instruments, and hence, the entire range of financial markets.

Following are the reasons as to why the world of finance prefers a securitised financial instrument to the underlying financial claim in its original form:

1. Financial claims often involve sizeable sums of money, clearly outside the reach of the small investor. The initial response to this was the development of financial intermediation: an intermediary such as a bank would pool together the

resources of the small investors and use the same for the larger investment need of the user. However, then came the second difficulty, noted below.

2. Small investors are typically not in the business of investments, and hence, liquidity of investments is most critical for them. Underlying financial transactions need fixity of investments over a fixed time, ranging from a few months to may be a number of years. This problem could not even be sorted out by financial intermediation, since if the intermediary provided a fixed investment option to the seeker, and itself sought funds with an option for liquidity, it would get caught into serious problems of a mismatch. Hence, the answer was a marketable instrument.

3. Generally, instruments are easier understood than financial transactions. An instrument is homogenous, usually made in a standard form, and generally containing standard issuer obligations. Hence, it can be understood generically. Besides, an important part of investor information is the quality and price of the instrument, and both are far easier known in case of instruments than in case of underlying financial transactions.

In short, the need for securitisation was almost inescapable, and present day's financial markets would not have been what they are, unless some standard thing that market players could buy and sell, that is, financial securities, were available.

So powerful is the economic logic for securitisation that the trend towards securitisation knows no limits. Capital markets are today a place where everything is traded: from claims over entities to claims over assets, to risks, and rewards.

Securitisation of receivables:

One of the applications of the securitisation technique has been in creation of marketable securities out of or based on receivables. The intention of this application is to afford marketability to financial claims in the form of receivables. Obviously, this application has been applied to those entities where receivables form a large part of the total assets of the entity. Besides, to be packaged as a security, the ideal receivable is one which is repayable over or after a certain period of time, and there is contractual certainty as to its payment. Hence, the application was traditionally principally directed towards housing/ mortgage finance companies, car rental companies, leasing and hire-purchase companies, credit cards companies, hotels, etc. Soon, electricity companies, telephone companies, real estate hiring companies, aviation companies etc. joined as users of securitisation. Insurance companies are the latest of the lot to make an innovative use of securitisation of risk and receivables, though the pace at which securitisation markets are growing, the word "latest" is not without the risk of being stale soon.

Though the generic meaning of securitisation is every such process whereby financial claims are transformed into marketable securities, in the sense in which we are concerned with this term here in this book, securitisation is a process by which cashflows or claims against third parties of an entity, either existing or future, are identified, consolidated, separated from the originating entity, and then fragmented into "securities" to be offered to investors.

Securitisation of receivables is a unique application of the concept of securitisation. For most other securitisations, a claim on the issuer himself is being securitised. For example, in case of issuance of debenture, the claim is on the issuing company only. In case of receivable, what is being securitised is a claim on the third party /parties, on whom the issuer has a claim. Hence, what the investor in receivable-securitised product gets is a claim on the debtors of the originator. This may at times be further include, by way of recourse, a claim on the originator himself.

The involvement of the debtors in receivable securitisation process adds unique dimensions to the concept, of which at least two deserve immediate mention.

One, the very legal possibility of transforming a claim on a third party as a marketable document. It is easy to understand that this dimension is unique to securitisation of receivables, since there is no legal difficulty where an entity creates a claim on itself, but the scene is totally changed where rights on other parties are being turned into a tradeable commodity. Two, it affords to the issuer the rare ability to originate an instrument which hinges on the quality of the underlying asset. To state it simply, as the issuer is essentially marketing claims on others, the quality of his own commitment becomes irrelevant if the claim on the debtors of the issuer is either market-acceptable or is duly secured. Hence, it allows the issuer to make his own credit-rating insignificant or less-significant, and the intrinsic quality of the asset more critical.

Terminology

Though there is a complete terminology appended to this Chapter, this section will help the reader to quickly get familiarised with the essential securitisation jargon.

The entity that securitises its assets is called the **originator**: the name signifies the fact that the entity was responsible for originating the claims that are to be ultimately securitised. There is no distinctive name for the investors who invest their money in the instrument: therefore, they might simply be called **investors**.

The claims that the originator securitises could either be existing claims, or existing assets (in form of claims), or expected claims over time. In other words, the securitised assets could be either existing receivables, or receivables to arise in future. The latter, for the sake of distinction, is sometimes called **future flows securitisation**, in which case the former is a case of **asset-backed securitisation**.

In US markets, another distinction is mostly common: between **mortgage-backed securities** and **asset-backed securities**. This only is to indicate the distinct application: the former relates to the market for securities based on mortgage receivables, which in the USA forms a substantial part of total securitisation markets, and securitisation of other receivables.

Since it is important for the entire exercise 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 a 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.

Since securitisation involves a transfer of receivables from the originator, it would be inconvenient, to the extent of being impossible, to transfer such receivables to the investors directly, since the receivables are as diverse as the investors themselves. Besides, the base of investors could keep changing as the resulting security is essentially a marketable security. Therefore, it is necessary to bring in an intermediary that would hold the receivables on behalf of the end investors. This entity is created solely for the purpose of the transaction: therefore, it is called a **special purpose vehicle (SPV)** or a **special purpose entity (SPE)** or, if such entity is a company, **special purpose company (SPC)**. The function of the SPV in a securitisation transaction could stretch from being a pure conduit or intermediary vehicle, to a more active role in reinvesting or reshaping the cashflows arising from the assets transferred to it, which is something that would depend on the end objectives of the securitisation exercise.

Therefore, the originator transfers the assets to the SPV, which holds the assets on behalf of the investors, and issues to the investors its own securities. Therefore, the SPV is also called **the issuer**.

There is no uniform name for the securities issued by the SPV as such securities take different forms. These securities could either represent a direct claim of the investors on all that the SPV collects from the receivables transferred to it: in this case, the securities are called **pass through certificates** or **beneficial interest certificates** as they imply certificates of proportional beneficial interest in the assets held by the SPV. Alternatively, the SPV might be re-configuring the cashflows by reinvesting it, so as to pay to the investors on fixed dates, not matching with the dates on which the transferred receivables are collected by the SPV. In this case, the securities held by the investors are called **pay through certificates**. The securities issued by the SPV could also be named based on their risk or other features, such as **senior notes** or **junior notes**, **floating rate notes**, etc.

Another word commonly used in securitisation exercises is **bankruptcy remote transfer**. What it means is that the transfer of the assets by the originator to the SPV is such that even if the originator were to go bankrupt, or get into other financial difficulties, the rights of the investors on the assets held by the SPV is not affected. In other words, the investors would continue to have a paramount interest in the assets irrespective of the difficulties, distress or bankruptcy of the originator.

Features of securitisation:

A securitised instrument, as compared to a direct claim on the issuer, will generally have the following features:

Marketability:

The very purpose of securitisation is to ensure marketability to financial claims. Hence, the instrument is structured so as to be marketable. This is one of the most important feature of a securitised instrument, and the others that follow are mostly imported only to ensure this one. The concept of marketability involves two postulates: (a) the legal and systemic possibility of marketing the instrument; (b) the existence of a market for the instrument.

As far as the legal possibility of marketing the instrument is concerned, traditional mercantile law took a contemporaneous view of marketable documents. In most jurisdictions of the world, laws dealing with marketable instruments (also referred to as negotiable instruments) were mostly limited in application to what were then in circulation as such. Besides, the corporate laws mostly defined and sought to regulate issuance of very usual corporate financial claims, such as shares, bonds and debentures. For any codified law, this is not unexpected, since laws do not lead commerce: most often, they follow, as the concern of the law-maker is mostly regulatory and not promotional.

Hence, in most jurisdictions of the world, well-coded laws exist to enable and regulate the issuance of traditional forms of securitised claims, such as shares, bonds, debentures and trade paper (negotiable instruments). Most countries lack in legal systems pertaining to other securitised products, of recent or exotic origin, such as securitisation of receivables. On a policy plane, it is incumbent on the part of the regulator to view any securitised instrument with the same concern as in case of traditional instruments, for reasons of investor protection.

However, it needs to be noted that where a law does not exist to regulate issuance of a securitised instrument, it is naive to believe that the law does not permit such issuance. As regulation is a design by humanity itself, it would be ridiculous to presume that everything that is not regulated is not even allowed. Regulation is an exception and freedom is the rule.

The second issue is one of having or creating a market for the instrument. Securitisation is a fallacy unless the securitised product is marketable. The very purpose of securitisation will be defeated if the instrument is loaded on to a few professional investors without any possibility of having a liquid market therein. Liquidity to a securitised instrument is afforded either by introducing it into an organised market (such as securities exchanges) or by one or more agencies acting as market makers in it, that is, agreeing to buy and sell the instrument at either pre-determined or market-determined prices.

Merchantable quality:

To be market-acceptable, a securitised product has to have a merchantable quality. The concept of merchantable quality in case of physical goods is something which is acceptable to merchants in normal trade. When applied to financial products, it would mean the financial commitments embodied in the instruments are secured to the investors' satisfaction. "To the investors' satisfaction" is a relative term, and therefore, the originator of the securitised instrument secures the instrument based on the needs of the investors. The general rule is: the more broad the base of the investors, the less is the investors' ability to absorb the risk, and hence, the more the need to securitise.

For widely distributed securitised instruments, evaluation of the quality, and its certification by an independent expert, viz., **rating**, is common. The rating serves for the benefit of the lay investor, who is otherwise not expected to be in a position to appraise the degree of risk involved.

In case of securitisation of receivables, the concept of quality undergoes drastic change **making rating is a universal requirement for securitisations**. As already discussed, securitisation is a case where a claim on the debtors of the originator is being bought by the investors. Hence, the quality of the claim of the debtors assumes significance, which at times enables to investors to rely purely on the credit-rating of debtors (or a portfolio of debtors) and so, make the instrument totally independent of the oringators' own rating.

Wide Distribution:

The basic purpose of securitisation is to distribute the product. The extent of distribution which the originator would like to achieve is based on a comparative analysis of the costs and the benefits achieved thereby. Wider distribution leads to a cost-benefit in the sense that the issuer is able to market the product with lower return, and hence, lower financial cost to himself. But wide investor base involves costs of distribution and servicing.

In practice, securitisation issues are still difficult for retail investors to understand. Hence, most securitisations have been privately placed with professional investors. However, it is likely that in to come, retail investors could be attracted into securitised products.

Homogeneity:

To serve as a marketable instrument, the instrument should be packaged as into homogenous lots. Homogeneity, like the above features, is a function of retail marketing. Most securitised instruments are broken into lots affordable to the marginal investor, and hence, the minimum denomination becomes relative to the needs of the smallest investor. Shares in companies may be broken into slices as small as Rs. 10 each, but debentures and bonds are sliced into Rs. 100 each to Rs. 1000 each. Designed for larger investors, commercial paper may be in denominations as high as Rs. 5 Lac. Other securitisation applications may also follow this logic.

The need to break the whole lot to be securitised into several homogenous lots makes securitisation an exercise of integration and differentiation: integration of those several assets into one lump, and then the latter's differentiation into uniform marketable lots. This often invites the next feature : an intermediary to achieve this process.

Special purpose vehicle:

In case the securitisation involves any asset or claim which needs to be integrated and differentiated, that is, unless it is a direct and unsecured claim on the issuer, the issuer will need an intermediary agency to act as a repository of the asset or claim which is being securitised. Let us take the easiest example of a secured debenture, in essence, a secured loan from several investors. Here, security charge over the issuer's several assets needs to be integrated, and thereafter broken into marketable lots. For this purpose, the issuer will bring in an intermediary agency whose basic function is to hold the security charge on behalf of the investors, and then issue certificates to the investors of beneficial interest in the charge held by the intermediary. So, whereas the charge continues to be held by the intermediary, beneficial interest therein becomes a marketable security.

The same process is involved in securitisation of receivables, where the special purpose intermediary holds the receivables with itself, and issues beneficial interest certificates to the investors.

Securitisation and financial disintermediation:

Securitisation is often said to result into financial disintermediation. This concept needs to be elaborated. The best way to understand this concept is to take the case of corporate debentures, a well-understood security.

As was discussed earlier, if one imagines a financial world without securities (and such world is only imaginary), all financial transactions will be carried only as one-to-one relations. For example, if a company needs a loan, if will have to seek such loan from the lenders, and the lenders will have to establish a one-to-one relation with the company. Each lender has to understand the borrowing company, and to look after his loan. This is often difficult, and hence, there appears a financial intermediary, such as a bank in this case, which pools funds from a lot of such investors, and uses these pooled funds to lend to the company. Now, let us suppose the company securitises the loan, and issues debentures to the investors. Will this eliminate the need for the intermediary bank, since the investors may now lend to the company directly in small amounts each, in form of a security which is easy to appraise, and which is liquid ?

Utilities added by financial intermediaries:

A financial intermediary initially came in picture to avoid the difficulties in a direct lender-borrower relation between the company and the investors. The difficulties could have been one or more of the following:

(a) **Transactional difficulty:** An average small investor would have a small amount of sum to lend whereas the company's needs would be massive. The intermediary bank pools the funds from small investors to meet the typical needs of the company. The intermediary may issue its own security, of smaller value.

(b) **Informational difficulty**: An average small investor would either not be aware of the borrower company or would not know how to appraise or manage the loan. The intermediary fills up this gap.

(c) **Perceived risk:** The risk as investors perceive in investing in a bank may be much lesser than that of investing directly in the company, though in reality, the financial risk of the company is transposed on the bank. However, the bank is a pool of several such individual risks, and hence, the investors' preference of a bank to the borrower company is reasonable.

Securitisation of the loan into bonds or debentures fills up all the three difficulties in direct exchange mentioned above, and hence, avoids the need for a direct intermediation. It avoids the transactional difficulty by breaking the lumpy loan into marketable lots. It avoids informational difficulty because the securitised product is offered generally by way of a public offer, and its essential features are well disclosed. It avoids the perceived risk difficulty too, since the instrument is generally well-secured, and is rated for the investors' satisfaction.

Securitisation: changes the function of intermediation:

Hence, it is true to say that securitisation leads to a degree of disintermediation. Disintermediation is one of the important aims of a present-day corporate treasurer, since by leap-frogging the intermediary, the company intends to reduce the cost of its finances. Hence, securitisation has been employed to disintermediate.

It is, however, important to understand that securitisation does not eliminate the need for the intermediary: it merely redefines the intermediary's loan. Let us revert to the above example. If the company in the above case is issuing debentures to the public to replace a bank loan, is it eliminating the intermediary altogether ? It would possibly be avoiding the bank as an intermediary in the financial flow, but would still need the services of an investment banker to successfully conclude the issue of debentures.

Hence, securitisation changes the basic role of financial intermediaries. Traditionally, financial intermediaries have emerged to make a transaction possible by performing a pooling function, and have contributed to reduce the investors' perceived risk by substituting their own security for that of the end user. Securitisation puts these services of the intermediary in a background by making it possible for the end-user to offer these features in form of the security, in which case, the focus shifts to the more essential function of a financial intermediary: that of distributing a financial product. For example, in the above case, where the bank being the earlier intermediary was eliminated and instead the services of an investment banker were sought to distribute a debenture issue, the focus shifted from the pooling utility provided by the banker to the distribution utility provided by the investment banker.

This has happened to physical products as well. With standardisation, packaging and branding of physical products, the role of intermediary traders, particularly retailers, shifted from those who packaged smaller qualities or provided to the customer assurance as to quality, to the ones who basically performed the distribution function.

Securitisation seeks to eliminate funds-based financial intermediaries by fee-based distributors. In the above example, the bank was a fund-based intermediary, a reservoir of funds, whereas the investment banker was a fee-based intermediary, a catalyst, a pipeline of funds. Hence, with increasing trend towards securitisation, the role of fee-based financial services has been brought into the focus.

In case of a direct loan, the lending bank was performing several intermediation functions noted above: it was distributor in the sense that it raised its own finances from a large number of small investors; it was appraising and assessing the credit risks in extending the corporate loan, and having extended it, it was managing the same. Securitisation splits each of these intermediary functions apart, each to be performed by separate specialised agencies. The distribution function will be performed by the investment bank, appraisal function by a credit-rating agency, and management function possibly by a mutual fund who manages the portfolio of security investments by the investors. Hence, securitisation replaces fund-based services by several fee-based services.

Securitisation: changing the face of banking:

Note the quotation with which we began this Chapter - it says securitisation is slowly but definitely changing the face of modern banking and by the turn of the new millennium, securitisation would have transformed banking into a new-look function.

Banks are increasingly facing the threat of disintermediation. When asked why he robbed banks, the infamous American criminal Willie Sutton replied "that's where the money is." No more so, a bank would say ! In a world of securitized assets, banks have diminished roles. The distinction between traditional bank lending and securitized lending clarifies this situation.

Traditional bank lending has **four functions**: originating, funding, servicing, and monitoring. Originating means making the loan, funding implies that the loan is held on the balance sheet, servicing means collecting the payments of interest and principal, and monitoring refers to conducting periodic surveillance to ensure that the borrower has maintained the financial ability to service the loan. Securitized lending introduces the possibility of selling assets on a bigger scale and eliminating the need for funding and monitoring.

The securitized lending function has only **three steps**: originate, sell, and service. This change from a four-step process to a three-step function has been described as the **fragmentation** or separation of traditional lending.

Capital markets fuelled securitisation:

The fuel for the disintermediation market has been provided by the capital markets:

Professional and publicly available rating of borrowers has eliminated the informational advantage of financial intermediaries. Imagine a market without rating agencies: any one who has to take an exposure in any product or entity has to appraise the entity. Obviously enough, only those who are able to employ high-degree analytical skills will be able to survive. However, the availability of professionally and systematically conducted ratings has enabled lay investors to rely on the rating company's professional judgement and invest directly in the products or instruments of user entities than to go through financial intermediaries.

- The development of capital markets has re-defined the role of bank regulators. A bank supervisory body is concerned about the risk concentrations taken by a bank. More the risk undertaken, more is the requirement of regulatory capital. On the other hand, if the same assets were to be distributed through the capital market to investors, the risk is divided, and the only task of the regulator is that the risk inherent in the product is properly disclosed. The market sets its own price for risk - higher the risk, higher the return required.

Capital markets tend to align risks to risk takers. Free of constraints imposed by regulators and risk-averse depositors and bank shareholders, capital markets efficiently align risk preferences and tolerances with issuers (borrowers) by giving providers of funds (capital market investors) only the necessary and preferred information. Any remaining informational advantage of banks is frequently offset by other features of the capital markets: variety of offering methods, flexibility of timing and other structural options. For borrowers able to access capital markets directly, the cost of capital will be reduced according to the confidence that the investor has in the relevance and accuracy of the provided information.

As capital markets become more complete, financial intermediaries become less important as cotact points between borrowers and savers. They become more important, however, as specialists that (1) complete markets by providing new products and services, (2) transfer and distribute various risks via structured deals, and (3) use their reputational capital as delegated monitors to distinguish between high- and low-quality borrowers by providing *third-party certifications of creditworthiness. These changes represent a shift away from the administrative structures of traditional lending to market-oriented structures for allocating money and capital.

In this sense, securitisation is not really-speaking synonymous to disintermediation, but distribution of intermediary functions amongst specialist agencies.

Securitisation and structured finance:

Securitisation is a "structured financial instrument". "Structured finance" has become a buzzword in today's financial market. What it means is a financial instrument structured or tailored to the risk-return and maturity needs of the investor, rather than a simple claim against an entity or asset.

Does that mean any tailored financial product is a structured financial product? In a broad sense, yes. But the popular use of the term structured finance in today's financial world is to refer to such financing instruments where the financier does not look at the entity as a risk: but tries to align the financing to specific cash accruals of the borrower.

On the investors side, securitisation seeks to structure an investment option to suit the needs of investors. It classifies the receivables/cash flows not only into different maturities but also into senior, mezzanine and junior notes. Therefore, it also aligns the returns to the risk requirements of the investor.

Securitisation as a tool of risk management:

Securitization is more than just a financial tool. It is an important tool of risk management for banks that primarily works through risk removal but also permits banks to acquire securitized assets with potential diversification benefits. When assets are removed from a bank's balance sheet, without recourse, all the risks associated with the asset are eliminated, save the risks retained by the bank. Credit risk and interest-rate risk are the key uncertainties that concern domestic lenders. By passing on these risks to investors, or to third parties when credit enhancements are involved, financial firms are better able to manage their risk exposures.

In today's banking, securitisation is increasingly being resorted to by banks, along with other innovations such as **credit derivatives** to manage credit risks.

Securitisation and credit derivatives:

Credit derivatives are only a logical extension of the concept of securitisation. A credit derivative is a non-fund based contract when one person agreed to undertake, for a fee, the risk inherent in a credit without acting taking over the credit. The risk could be undertaken either by guaranteeing against a default, or by guaranteeing the total expected return from the credit transaction. While the former could be just another form of traditional guarantees, the latter is the true concept of credit derivatives. Thus, if B bank has a concentration in say Iron and Steel segment while A bank has concentration in Textiles, the two can diversify their risks, without actually taking financial exposure, by engaging in credit derivatives. A can agree to guarantee the returns of B from a part of its Iron and Steel exposures, and B can guarantee the returns of A from Textiles (derivatives do not necessarily have to be reciprocal). Thus, A is now earning both from its own exposure in Iron and Steel, as also from the fee-based exposure it has taken in Textiles.

Credit derivatives were logically the next step in development of securitisation. Securitisation development was premised on credit being converted into a commodity. In the process, the risk inherent in credits was being professionally measured and rated. In the second step, one would argue that if the risk can be measured and traded as a commodity with the underlying financing involved, why can't the financing and the credit be stripped as two different products?

The development of credit derivatives has not reduced the role for securitisation: it has only increased the potential for securitisation. Credit derivatives is only a tool for risk management: securitisation is both a tool for risk management as also treasury management. Entities that want to go for securitisation can easily use credit derivatives as a credit enhancement device, that is, secure total returns from the portfolio by buying a derivative, and then securitise the portfolio.

Economic impact of securitisation:

Securitisation is as necessary to the economy as any organised markets are. While this single line sums up the economic significance of securitisation, the following can be seen as the economic merits in securitisation:

Facilitates creation of markets in financial claims:

By creating tradeable securities out of financial claims, securitisation helps to create markets in claims which would, in its absence, have remained bilateral deals. In the process, securitisation makes financial markets more efficient, by **reducing transaction costs**.

Disperses holding of financial assets:

The basic intent of securitisation is to spread financial assets amidst as many savers as possible. With this end in view, the security is designed in minimum size marketable lots as necessary. Hence, it results into dispersion of financial assets.One should not underrate the significance of this factor just because most of the recently developed securitisations have been lapped up by institutional investors. Lay investors need a certain cooling-off period before they understand a financial innovation. Recent securitisation applications, viz., mortgages, receivables, etc. are, therefore, yet to become acceptable to lay investors. But given their attractive features, there is no reason why they will not.

Promotes savings:

The availability of financial claims in a marketable form, with proper assurance as to quality in form of credit ratings, and with double safety-nets in form of trustees, etc., securitisation makes it possible for the lay investors to invest in direct financial claims at attractive rates. This has salubrious effect on savings.

Reduces costs:

As discussed above, securitisation tends to eliminate fund-based intermediaries, and it leads to specialisation in intermediation functions. This saves the end-user company from intermediation costs, since the specialised-intermediary costs are service-related, and generally lower.

Diversifies risks:

Financial intermediation is a case of diffusion of risk because of accumulation by the intermediary of a portfolio of financial risks. Securitisation further diffuses such diversified risk to a wide base of investors, with the result that the risk inherent in financial transactions gets very widely diffused.

Focuses on use of resources, and not their ownership:

Once an entity securitises its financial claims, it ceases to be the owner of such resources and becomes merely a trustee or custodian for the several investors who thereafter acquire such claim. Imagine the idea of securitisation being carried further, and not only financial claims but claims in physical assets being securitised, in which case the entity needing the use of physical assets acquires such use without owning the property. The property is diffused over an investor crowd.In this sense, **securitisation carries Gandhi's idea of a capitalist being a trustee of resources and not the owner. Securitisation in its logical extension will enable enterprises to use physical assets even without owning them, and to disperse the ownership to the real owner thereof: the society**.

The alchemy of securitisation: is the sum of parts more than the whole?

An essential economic question often raised is: does securitisation lead to any overall social benefit? After all, all that securitisation does is to break a company, a set of various assets, into various subsets of classified assets, and offer them to investors. Imagine a world without securitisation: each investor would be taking a risk in the unclassified, composite company as a whole. So, how does it serve any economic purpose, if the company is "de-composed" and sold to different investors?

A New Zealand-based scholar takes the following example to illustrate the alchemy of securitisation:

To appreciate the underlying economics driving a securitisation, consider a hypothetical holding company XYZ Ltd, which has on its balance sheet nothing other than three wholly-owned subsidiaries, X, Y & Z. (The process of securitisation can be thought of as treating distinguishable pools of assets as if they were the wholly-owned subsidiaries, X, Y and Z.)

Assume X is 100% debt financed (5 year debentures issued at 9%) with its only asset a single 5 year loan to an AAA-rated borrower paying 10%.

Assume Y is a new software company with no earnings or performance history, but with projections for extremely attractive, albeit volatile, future earnings.

Assume Z is a well-known manufacturing company with predictable but unspectacular earnings.

If XYZ went to the debt markets seeking additional senior unsecured funding, potential investors would face the difficult task of evaluating its assets and assessing its debt repaying abilities. The assessed cost of marginal XYZ borrowing might consist of an "average" of the conservatively calculated returns on the assets of the segments that comprise XYZ. Note that this average would necessarily reflect known and unknown synergies, and costs and associative risks arising from the collective ownership of the constituent parts (i.e., the group's imputed contribution for credit support, insolvency risk and liability recourse) and would likely include an "uncertainty" discount.

Now consider the probable outcomes if XYZ were to legally sell or "spin-off" the ownership of one or more of its "parts." In exchange for the exclusive rights to the cash flows from X, investors would return to XYZ maximum equivalent value in the form of cash.

Such an offering:

- appeals to a wide range of investors, including those with a preference for, and superior information regarding, the risk represented by X's obligors and those new investors who have had an aversion for the risk presented by the associated costs and risks represented by Y and Z
- returns to XYZ the full value the market attaches to the certainty of the information concerning X, now free of any discount imposed by the uncertainty of the information regarding Y and Z.

Admittedly, the value of the resulting XYZ shares depends in part on the disposition of the cash received from the spin-off. If XYZ retains the cash, there may be a discount or revaluation resulting from the market's assessment of XYZ's ability to achieve a return equal or better than it would have earned from keeping the asset.

There is always one clear collateral benefit to the resulting XYZ that derives from any divestment. The perceived value of the remaining components is relieved of any previously imposed discount for the disposed component's credit support and insolvency risk.

Holding aside separate considerations of corporate strategy and intentional and coincidental internal synergies, to the extent that the consideration received from the divestment improves (in the perception of the market) the capital structure of the resulting XYZ and/or improves the marginal funding cost for the resulting XYZ, the decision to divest or securitise is simplified. If the information held by XYZ concerning any of its segments is not or cannot be fully disclosed, or when disclosed will not be fully or accurately valued, the correct decision is to retain the asset.

Without securitisation, XYZ's bank or factor faces significant and largely irreducible costs of evaluating the marginal impact on XYZ's borrowing cost from XYZ's pledging of assets (receivables) and of evaluating similar information for each other borrower that the lender or factor finances. If the imposed cost of borrowing is to be judged solely on the assets (which is, as we've shown, the most efficient way to assess the true cost of asset based borrowing), evaluating each pool of assets and assessing the likelihood that the cash flows from them will be uninterrupted must be repeated for each borrowing.

By developing a market for asset-specific expertise (not the least of which is represented by the expertise of the rating agencies), and by relying on the capital markets to determine the best price for the rated asset-backed securities (such rating representing the expression of the information provided by the developed expertise), the cost of borrowings for issuers using properly organised securitisation structures has steadily decreased and is well below the cost of borrowing from a lending institution.

Capturing scale and volume efficiencies

By aggregating similarly originated assets into a sufficiently large pool, the consequences of an individual receivable defaulting, and the levels of risk of default, are minimised. If we further collect and aggregate dissimilar pools of assets, and issue securities backed by the aggregated cash flows derived from the underlying assets, as a result of rules of probability and the basic principles of diversification, the marginal risk to the purchaser (investor) of such a security is significantly less than the risk of holding even a pool of individual receivables. And it is far less than the risk associated with a single receivable.

If a borrower can identify, segregate and then satisfactorily describe for investors a pool of securitisable assets otherwise held on its balance sheet, the securitisation process can give that borrower a lower cost of funding and improve its balance sheet management. The borrower faced with such an opportunity who chooses not to securitise runs the risk of handicapping its ability to compete.

risks and benefits of securitisation:

The **Bank for International Settlements** in a 1992 publication titled Asset Transfers and Securitisation had the following to say on the risks and benefits of securitisation:

The possible effects of securitisation on financial systems may well differ between countries because of differences in the structure of financial systems or because of differences in the way in which monetary policy is executed. In addition, the effects will vary depending upon the stage of development of securitisation in a particular country. The net effect may be potentially beneficial or harmful, but a number of concerns are highlighted below that may in certain circumstances more than offset the benefits. Several of these concerns are not principally supervisory in nature, but they are referred to here because they may influence monetary authorities' policy on the development of securitisation markets.

While asset transfers and securitisation can improve the efficiency of the financial system and increase credit availability by offering borrowers direct access to end-investors, the process may on the other hand lead to some diminution in the importance of banks in the financial intermediation process. In the sense that securitisation could reduce the proportion of financial assets and liabilities held by banks, this could render more difficult the execution of monetary policy in countries where central banks operate through variable minimum reserve requirements. A decline in the importance of banks could also weaken the relationship between lenders and borrowers, particularly in countries where banks are predominant in the economy.

One of the benefits of securitisation, namely the transformation of illiquid loans into liquid securities, may lead to an increase in the volatility of asset values, although credit enhancements could lessen this effect. Moreover, the volatility could be enhanced by events extraneous to variations in the credit standing of the borrower. A preponderance of assets with readily ascertainable market values could even, in certain circumstances, promote a liquidation as opposed to going-concern concept for valuing banks.

Moreover, the securitisation process might lead to some pressure on the profitability of banks if non-bank financial institutions exempt from capital requirements were to gain a competitive advantage in investment in securitised assets.

Although securitisation can have the advantage of enabling lending to take place beyond the constraints of the capital base of the banking system, the process could lead to a decline in the total capital employed in the banking system, thereby increasing the financial fragility of the financial system as a whole, both nationally and internationally. With a substantial capital base, credit losses can be absorbed by the banking system. But the smaller that capital base is, the more the losses must be shared by others. This concern applies, not necessarily in all countries, but especially in those countries where banks have traditionally been the dominant financial intermediaries.