SECURITIZATION AS A FUNDING SOURCE OF COMPANIES

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DOI: https://doi.org/10.31410/EMAN.2021.43

Abstract: *Securitization is in wide use and a component of many risk transfer mechanisms between various parties. It is based on selling risky assets in absolute form, as well as the synthetic transfer of specific risk aspects. This paper aims to define securitization, various contexts of its use, transaction participants and their motivation. Securitization in practice is a process in which loans, receivables and other assets are gathered into pools (packages). Money flows in connection with them are employed as well as economic value as support to securities settlements. Securitization is turning illiquid securities and illiquid assets into liquid securities and liquid assets. The final result of securitization is providing funding for activities of companies by selling their assets gathered into pools (packages), instead of using loans. Methods used in this paper are desk research, as well as the method of analysis, practical application worldwide, etc. This paper proves that securitization can practically be based on any asset the relative value of which can be determined, or which generates relatively predictable future income flow, which does contribute to providing funding of current business activities of a company.*

Keywords: *Securitization, Pool, Assets, Risks.*

1. INTRODUCTION

1.1. Objectives of Securitization and Structuring

Securitization enables the creation of securities based on the total sum of the assets that are most attractive to many different investors. Each financial system is complex and within it, there are different organizational forms of financing as the financial area is very wide, and it is present in all spheres of social and economic life. Determining a country's economic policy is a very responsible job because very important decisions are made in the legal area, budget area, decisions on economic development policies, etc.

When it comes to an example of structuring, using mortgage loans as a representative asset, helps to classify the securitization in terms of the borrower's loan. The market can be roughly divided into primary borrowres and subprimary borrowers. The primary borrowers are those with high credit quality since they had a good employment and credit history in the past, an income sufficient to repay the loan without compromising their creditworthiness as well as sufficient equity in the underlying assets. Granted loans to such individuals are roughly classified as primary loans, as they have had a low incidence of delays and defaults in the past.

On the contrary, loans granted to borrowers with low credit quality with a potential to be in defaults are classified as subprimal loans so those borrowers are referred to as subprimal borrowers. The approval of subprimary loans relies on non-traditional measures of the credit risk assessments since the borrowers have lower incomes, fewer assets and poor credit history.

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After the loan is granted, the loan portfolio has to be serviced by special departments in order to monitor the repayments of subprimary loans. If there is a delay in repayment of the subprime loan, the servicers take immediate action either by helping the borrowers to meet their obligations or by mitigating possible losses due to default.

It is necessary to distinguish between transactions related to primary and subprimal loans because it affects the credit rating. The high credit quality of loans in the primary sector quite simplifies raising the credit ratings. For example, the mortgage loans that meet the standards are considered primary loans while the securities performed with the loans are referred to as agency transactions (agency deals).

Increasing the credit rating in the agency transactions is achieved through the guarantee mechanisms given by the agency that broadcasts the transaction. This guarantee is paid by the transaction sponsor via fee. In the case of the other primary loans' securitization, the used mechanism for increasing the credit rating is a subordinated structure where there are classes of bonds that have different priorities in relation to cash flows and write-offs of losses. Structures are flexible in terms of creating the most efficient credit rating raising in primary transactions, determining the necessary credit rating is often conditioned by the rating agency, while the suborded structures are relatively simple. The execution of the transaction is mostly influenced by the maturity date of the bond.

1.2. Ruling Perceptions

Securitization of sub primary loans has to be highlighted as in the case of the securitized primary loans, the sub primary loans securitization will have bond classes with different priorities compared to the cash flow. However, compared to the securitization of the primary loans, the securitization of the sub-primary loans requires a higher amount to raise the credit rating to create the older bond classes. This fact affects the economic justification factor of the primary transactions in relation to sub primary transactions. The motive for creating an efficient structure relates to the primary transactions is to shape the older bonds, while the goal refers to the subprimary transactions is to structure the transaction to produce an effective credit rating in order to protect the older bonds.

Although the structuring approach is similar in comparison to creating bond classes with different priorities and ratings, the credit rating-raising techniques used for the primary loans' securitization would not be effective enough if it has been applied to subprimary loans, especially if subording is used as the only form of credit support. There are at least two reasons for that. First, the subordinated bond classes would be higher compared to the bond classes in the primary loan securitization. In addition, the incremental interest rate paid by borrowers can be used optimally to provide credit support for older bond classes. For this reason, the securitization of subprimary loans uses a combination of mechanisms to raise the credit rating. Another reason is the cash flows allocation rules for the subprimary loan's securitization must have more tests to store older bond classes compared to the primary loan's securitization.

For the initiator, the investment bankers will structure the transaction by acting as agents or as the principals. It is not uncommon for some securitization to have dozens of bond classes, because maximizing the number of bond classes is not the goal of the structure. The only economic goal is to maximize the total revenue by selling all classes of bonds provided by pool assets. (In market jargon) the goal is to ensure the best *execution.* Alternatively, the goal is to acquire the lowest average cost for the financing.

Maximizing the assets securitization income can be achieved by structuring cash flow in two ways. First, shaping the cash flow of collateral to create the bond classes that better suit particular interest rate risk (i.e. effective duration, conversation and duration of the key rate) and yields or views of different investors. Another way of maximizing income in the assets securitization is when the investment banker tries to create more economical structures, especially for non-agency transactions where the cost of raising the credit rating is contained in the transaction through co-boarding mechanisms. In general, the securitization initiator in such cases will achieve better execution by creating the highest possible amount of the older bonds while at the same time receiving the highest possible income for the younger bond classes (i.e. sub-corporate bond classes and interests).

1.3. Future Income Securitization

Traditional transactions secured by the asset refer to the asset that exists, while the future flows transactions refer to the asset that is expected to be in place There is a source, business or infrastructure, from which the assets will arise. Business or infrastructure needs to be worked on to generate the revenue, in other words, the income is not created therefore the securities repayments are liquidated by themselves. On the other hand, the future flows are like corporate financing as the asset performance or infrastructure must be in place to see the cash flow that will repay the securities.

1.3.1. The Future Flows Can Be Securitized

The basic premise of the future flows` securitization is the framework's existence. Based on that the cash flows will occur in the future so they can be securitized. If the framework does not exist itself, the investors will expose themselves to the unknown risk, their rights would be less than insured lending.

The following future flows can be securitized: revenues from the sales of air tickets, electricity sales, telephone equipment rental, export revenues based on natural resources, etc.

1.3.2. Uncertain Receivables

The future flows receivables are uncertain and unpredictable therefore the initiator transfers a certain part of the receivables and keeps the excess above the transferred part as the seller interest. The transferred part is a basic receivable and it is based on the past recorded results. The transferred part is used to service investors, therefore the transferred part can be used as the requested funds for servicing the investors. The seller's interest varies depending on the initiation of the securitization in the process of the transaction.

1.3.3. Cash Flow Capturing

The future flow transaction essentially represents the cash flow capturing. The receivables sales mechanism is presumed to exist (the transaction is with receivables transfer) but it is obvious that the whole concept will not make sense unless the trust members have the ability to physically capture the cash flows that generate certain receivables before they are redirected to the initiator – since what is being sold has yet to be raised.

1.4. Categories Transaction Securitization

As the financial market matured and evolved, three general categories of securitization transactions were established. Financing and capital management transactions are the basic type of transactions in the securitization arena.

Initiators generate assets such as loans and receivables that represent the total payment obligations of their clients (debtors). When such assets are securitized (or interest per the asset), the initiator achieves liquidity. Clients typically do not know that the asset is securitized therefore there has been an effective change in controlling their obligation – the change does not have to be published, since the synthetic structure does not have to lead to any control changes but solely to risk transfer.

1.4.2. Arbitration Repackaging

Repackaging transactions are typically the Treasury Bills series issued as ABS (Asset Backed Securities) secured by the bond portfolio (including the ABS itself), credit derivatives, loan portfolio and other forms of credit risk. Arbitration exists between portfolio yield and the required total cost of bills, so the success is often measured by comparing the relative costs of the current assets "in the balance sheet" relative to possession through securitization structure.

1.4.3. Market Value Transactions

In relation to the market-based transactions, the asset manager must take certain measures, usually to sell the collateral, to liquidate assets. This puts the investor at liquidity and markets risk.

1.4.4. Transaction Characteristics and Participants in the Transaction

Securitization structures seem complex, but there are common characteristics that facilitate their understanding and enable analysis and comparison.

The initiator approves funds to the debtor, so the initiator buys or uses the assets. This creates financial assets. When it is created, the initiator usually continues to charge and manage the assets in accordance with the current lending and collection procedures. These activities are usually referred to as servicing and the party that performs it is called a servicer. To create the ABS (Asset Backed Securities), the initiator entrusts the assets to be securitized to another entity (it's usually the separate SPV (Special Purpose Vehicle). SPV or trustee issues debt securities for the capital markets. The Securities are typically bought by institutional investors (including banks, transaction brokers, insurance companies, pension funds and portfolio managers).

The Issuer uses the Treasury bills income to pay the purchase price of the asset being securitized. The transfer of initiator assets to the issuer is usually *a securitization with* receivables transfer (traditional securitization). Traditional securitization separates the assets from the assets in case of initiator's bankruptcy or insolvency. In line with that, the investors can expect payment only from the assets in case of the initiator's usual operations, as well as in the case of possible insolvency or bankruptcy. All these methods do not affect liquidity. An overview of the mechanisms is given in Table 1.

Table 1. Risk transfer mechanisms

Mechanism risk transfer	Measures taken	Effect on balance sheet
Traditional securitization	The initiator sells assets to SPV	The asset is usually erased from the initiator balance sheet
Assignment	The initiator ‘’assign’ its interest to pool assets that are securitized in favor of the SPV	In the practice, the asset is erased from the initiator’s balance sheet, but it is still in it – only risk and rights are transferred
Secured loan	SPV takes interest (Usually 1st priority)	Assets are still on the balance sheet
Default credit swap	SPV together with the initiator are in default credit swap, arranging the payment of certain amounts to the initiator in case of certain credit events in relation to the asset’s securitization	The asset remains on the initiators´ balance sheet
Guarantee	SPV guarantees to the initiator, but the regulations refer to loan derivatives may not be applied on the guaranty	The asset remains on the initiators´ balance sheet

Source: Commerzbank Securities / 2012.

2. CONCLUSION

A securitization is a form of structural financing. Common to all types of transactions is that transactions are structured to modify or redistribute collateral risk to different classes of investors based on the structure.

Securitization implies the pooling (packages) formation of the assets/receivables and securities emissions by a SPV. The result of the transaction is the corporation can obtain funds by selling the assets. The asset securitization process transforms pool assets into one or more securities, such as ABS (asset backed securities) Securitization is different from traditional financing methods as the cash flow is generated by assets can be used for one or more securities. Three advantages of securitization in relation to non-regression factoring and factoring with the modified regression right are: the essence of the securitization is primarily the monetization of financial assets in a way that reduces collateral, risk (credit risk, interest rate risk, risk of early repayment and liquidity risk) primarily for their repayment, but not for the performance of the particular project or entity.

The most important reasons the corporations use securitization are the possibility of reducing funding costs, the ability to diversify funding sources, the ability to manage corporate risk, reducing the capital requirements, the possibility of generating income on the service basis commission. A key role related to the bond emissions has the SPV since the entity separates the assets and it is used as collateral for securitization compared to the corporation that needs the funds (initiator/seller).

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