Securitization; For Funding & Risk Sharing

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What is securitization?

- Securitization is the pooling of cash flows and the issuance of securities backed by underlying assets.
- The repayment of securities is solely dependent on the performance of the assets.
- Securitization de-links the credit risk of the issuer from the securitization transaction.
Basic Model of Securitization

Borrowers (Obligors) → Originator (Bank/FI)

Receivables → Loan

Liquidity Support → SPV

Cash → Sell Receivables

Credit Enhancement

Cash → Securities

Investors
Types of securitization

- Residential mortgage backed securities (MBS)
- Asset backed securities (ABS)
- Collateralized debt obligations (CDO)
- Commercial mortgage backed securities (CMBS)
- Future flow securitization
Requirements for securitization

- Legal environment
- Accounting environment
- Regulatory environment
- Tax environment
- Back office systems/Information System
- Strong investor demand
Why securitize assets?

Efficient funding
- Lower Cost
- Alternative investor base
- Issuer’s credit rating becomes irrelevant

Improving balance sheet structure
- Improves capital utilization
- Releases capital
Why Securitize assets?

- Arbitrage – yield and term
- Enables better utilization of resources
- Risk management
- “Dress up” accounting profits if “true sale” criteria is satisfied
Benefits to investors?

- Better security
- Greater moral responsibility
- Create instruments to match investment objectives
- Better and more resilient credit ratings
Risks in securitization

- Credit Risk
- Recovery Risk
- Liquidity Risk
- Pre Payment & Yield Risk

Risk Mitigants
- Tranching, Cash reserves, Over Collateralization
- Loan to Value (LTV), Asset Depreciation Rates
- Liquidity Support
- Portfolio Seasoning
Static Pool Loss Curve

Chart 1: Static Pool Gross Loss Curve

Source: Fitch Ratings
Table 1: Principal Delinquency Bucketing

<table>
<thead>
<tr>
<th>Days Past Due (%)</th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
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<tbody>
<tr>
<td>1-30</td>
<td>5.5</td>
<td>6.0</td>
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<td>5.5</td>
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<tr>
<td>31-59</td>
<td>2.5</td>
<td>2.5</td>
<td>3.0</td>
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<tr>
<td>60-89</td>
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<td>1.0</td>
<td>1.25</td>
<td>1.5</td>
<td>1.75</td>
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<td>90-119</td>
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<td>0.25</td>
<td>0.25</td>
<td>0.5</td>
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<tr>
<td>120-150</td>
<td>0.25</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.4</td>
</tr>
</tbody>
</table>

Source: Fitch Ratings
Static Pool Pre-payment Curve

Chart 2: Static Pool Pre-payment Curve

% Principal Prepaid

0% 1% 2% 3% 4% 5% 6% 7% 8%

M1 M3 M6 M11 M16 M21 M26 M31 M36
Month Post Origination

Source: Fitch India
Securitization in Sri Lanka?

- Predominantly used for Auto Leases
- Not securitization, but Asset Backed Lending
- No “True Sale” -> “On Balance Sheet financing”
- The credit rating of the transaction is linked to the issuers credit rating
- Commingling risk of cash flows?
Current Model in Sri Lanka

- **Borrowers (Obligors)**
  - Receivables
  - Loan
- **Originator (Bank/FI)**
  - Cash
  - Pledge
  - Receipts
- **Trust**
  - Securities
- **Investors**
  - Cash
  - Recourse

**Credit Enhancement**
Risks management through securitization

Retain the client without the risk!!

- Loan: 8%
- Service & Collection: 1%
- Funding: 6%
- Originate: 1%
Basic CDO structure

- Bank
- SPV
- Coupons & principal
- Senior notes
- Mezzanine notes
- Equity

Flows:
- Loans
- Cash
- Funds
Impact to originator

- Not exposed to Credit & Interest Rate Risk
- Net income would be close – due to originating & servicing fees as well as the excess spread
- Cash flows improve
- Better utilization of capital & infrastructure
- Improves ROA / ROE
Impediments for Securitization in Sri Lanka

- Finance Leasing Act
- Concerns on the Loss of Parate Powers?
- Transaction Cost
- Registration Procedure
- Poor information systems
- Lack of education
Practical Issues in undertaking Securitization

- Greater disclosure of information
- Internal systems may take time to generate the information required
- Initial cost and time involved in the first transaction will be higher than other forms of financing
- Less flexible covenants
Way forward….

- Finance Leasing Act needs to be amended to facilitate securitization
- New Securitization Act?
- Transaction cost
- Registration Procedures
Way forward....

- Clear accounting treatment for securitization

- Clear tax treatment for securitization

- Internal information systems need to be modified
Way forward....

- Investors need to get used to taking on the risk of the securitized assets
- Investors need to be prepared to accept unscheduled cash flows
- RMBS could be undertaken under the existing legal framework
Panel Discussion

- Mr. Vajira Kulatilaka
  CEO, NDB Investment Bank

- Mr. Naomal Goonewardena
  Partner, Nithya Partners

- Mr. Ajith Fernando
  CEO, Capital Alliance