# Learning Module 17: Fixed Income Securitization

## LOS 17a: explain benefits of securitization for issuers, investors, economies, and financial markets

Securitization is a method that encompasses the pooling and transferring of the ownership of assets that generate cash flow, such as loans or receivables, to a special legal entity. This entity then offers securities, which are underpinned by these assets, to investors. For instance, a bank that has issued multiple home loans can pool these loans together and sell them to a Special Purpose Entity (SPE). The collection of assets is termed as securitized assets, often known as the reference portfolio or collateral. This distinct legal structure then releases securities to investors, which are backed by the pooled assets. The resultant cash flows are employed to cover interest and return the principal to these investors. Securitization establishes a direct connection between investors and borrowers for various loan types and receivables, yielding advantages for issuers, investors, economic systems, and financial marketplaces.

## Types of Asset-Backed Securities (ABS)

### Covered Bonds

Predominantly used by European banks, these involve designating a specific mortgage loan pool on the bank's ledger, distinct from other assets. For instance, Deutsche Bank might release bonds supported by home loan pools. If there is a default, investors can leverage the collateral for repayment. These bonds do not fully qualify as securitizations since they remain on the bank's balance sheet and payments come directly from the bank, not the loan pool's cash flow.

### Pass-through Securities

These embody true securitizations. A distinct legal entity receives assets, removed from the original balance sheet, and issues securities supported by these assets. As an example, a bank might transfer auto loans to an entity which then issues securities to investors. Payments from the asset pool are proportionally distributed across various risk levels.

### Bonds with Structural Enhancements

These securities aim to make payment patterns more consistent by channeling cash flows across predetermined tranches. They use tools like set payment schedules and tranching to cushion against unforeseen payment changes. Additionally, they might incorporate credit enhancements, such as reserve funds or overcollateralization, to further minimize risk.

### Mortgage-backed Securities (MBS)

MBS are ABS sustained by mortgage pools. They are distinct from ABS backed by non-mortgage assets. Tranching determines payment sequences and how losses are managed. For instance, an MBS by Freddie Mac might prioritize a senior tranche for payments and lastly for absorbing losses, while a junior tranche would be the opposite.

## Advantages of Securitization for Issuers

- Through securitization, banks can enhance their profitability. They achieve this by collecting origination charges and lessening capital obligations for loans traded to investors. By distinguishing between the initiation of a loan and its financing, banks can optimize efficiency considering risk.
- By offloading illiquid assets via securitization, banks can offload assets and the associated risks, resulting in superior risk oversight and better capital ratios in line with regulations.
- Securitization permits banks to exceed their balance sheet constraints when originating loans. This capability means they can offer more loans, which can invigorate economic progress.

## Advantages for Investors

- Securitization offers investors a chance to invest in securities funded by loans or receivables without directly managing those assets. This opens the door for a wider investor base to access private-sector debt.

- Investors can customize their risk and return perspectives by choosing from different tranches or categories of securities, each with its credit risk level. Such flexibility promotes portfolio diversification and aligns with specific investor preferences.
- Investing in securitized debt might yield greater returns compared to investing in traditional bonds, all the while maintaining a high credit rating.

## Advantages for Economic and Market Structures

- Securitization produces tradable securities that augment market liquidity. The feasibility of trading these assets in secondary markets aids investors in pinpointing balanced pricing, which in turn, boosts market efficacy.
- Securitization serves as an alternative financing mechanism for businesses, sidestepping conventional methods like bonds or equity. By consolidating assets eligible for securitization, firms can lower financing expenditures and realize superior capital returns than traditional borrowing avenues.
- Direct market access becomes possible for companies through securitization, eliminating the need for extra debt generation. This approach can sustain or elevate their creditworthiness whilst tapping into more cost-effective capital sources.
- The overarching system gains from securitization. It's beneficial for producers, consumers, and investors by allowing producers to delegate debt management, cutting down expenses for consumers, and presenting a variety of investment opportunities to investors.

## Question

Which of the following *best* describes the purpose of a Special Purpose Entity (SPE) in securitization?

A. To offer loans directly to borrowers.
B. To issue securities backed by pooled assets to investors.
C. To act as an intermediary between banks and borrowers.

**Solution**

The correct answer is **B.**

A Special Purpose Entity (SPE) receives pooled assets and issues securities supported by these assets to investors.

**A is incorrect:** An SPE does not directly offer loans; it handles the pooled assets.

**C is incorrect:** The SPE does not act as an intermediary but as a distinct legal structure that holds the pooled assets.

**LOS 17b: describe securitization, including the parties and the roles they play**

Securitization is the financial practice of pooling various types of contractual debt like auto loans and selling their related cash flows to third party investors as securities, which are typically characteristic of a blend of both bonds and stocks. It increases the liquidity of these assets and frees up capital for the original lender to finance more loans.

## Parties to a Securitization

1. Seller/Originator - Grants loans to customers which are then sold to an SPE as the first step of securitization.
2. Special Purpose Entity or Vehicle (SPE or SPV)- This separate, bankruptcy-remote entity buys the loans and uses them as collateral to issue ABS. The SPE's bankruptcy-remote status acts as a safety measure to ensure that the underlying assets of the securities are protected in case the originator goes bankrupt.
3. Servicer: The servicer is accountable for the administration of the loans, which covers the collection of payments, managing loan defaulters, and the disposal of assets if borrowers default.

Moreover, other important parties can include professionals like accountants, lawyers, trustees, underwriters, rating agencies, and potentially financial guarantors. Trustees safeguard the assets and perform duties as per the terms of the prospectus such as holding funds due to the ABS holders.

In addition to the conventional bond indenture and its associated covenants, there are two other critical legal documents in the securitization process. These documents bear resemblance to those used in an MBS transaction and include:

1. Purchase Agreement - Details the conditions and responsibilities of the seller and the SPE regarding the assets being sold. It provides investors with an assurance about the quality and legitimacy of the underlying assets.

2. Prospectus - Detailing the structure of the securitization, it illustrates the flow of payments to different parties and describes any credit enhancements used.

## Role of the SPE

SPEs are instrumental in securitization processes. Their primary function is to legally shield both the issuer and investors in an ABS transaction. A few key roles and characteristics of SPEs include:

1. **Protection from Bankruptcy**: SPEs ensure that securitizations remain unaffected even if the seller of the collateral goes bankrupt. This separation makes raising funds through securitization often more cost-effective than through corporate bonds backed by the same collateral.
2. **Credit Risk Decoupling**: Assets moved to an SPE are isolated from the originating company's credit risk. Consequently, the only credit risk investors face pertains to potential defaults by borrowers within the SPE. As long as these borrowers meet their obligations, the SPE can fulfill its commitments to security holders.
3. **Legal Ownership & Recognition**: In many jurisdictions, securitization is recognized as a true sale. This means the SPE holds complete legal ownership of the securitized assets, which are then removed from the seller's balance sheet. However, there is a caveat: transfers to SPEs could be contested in court as fraudulent transactions, and if deemed so, might be reversed.
4. **Jurisdictional Differences**: Not all countries share identical legal frameworks for SPEs. In regions where trust law is less established, challenges related to ABS issuance might arise. Hence, investors must be aware of and consider the legal nuances of the jurisdictions in which they operate.

## Question #1

Which document in the securitization process most likely details the conditions and responsibilities of the seller and the SPE concerning the assets being sold?

A. Prospectus
B. Purchase Agreement
C. Bond Indenture

The correct answer is **B.**

The Purchase Agreement lays out the conditions and responsibilities of the seller and the SPE regarding the assets being sold.

**A is incorrect:** The Prospectus details the structure of the securitization.

**C is incorrect:** Bond Indenture is related to bonds and not directly to the assets being sold in securitization.

## Question #2

In the securitization process, which entity is most likely responsible for providing periodic cash flow reports to ABS holders as stipulated in the terms of the prospectus?

A. Seller/Originator
B. Special Purpose Entity (SPE)
C. Trustee or Trustee Agent.

The correct answer is **C.**

The trustee or trustee agent is responsible for providing periodic cash flow reports to ABS holders as agreed upon in the terms of the prospectus.

**A is incorrect:** The Seller/Originator's role is primarily to grant loans and sell them to the SPE.

**B is incorrect**: While the SPE issues the securities, it does not typically handle the administrative duties associated with the cash flows.