

## SECURITISATION 1: THE FORWARD LINE OF FINANCING OPPORTUNITY

**G**rowth in global business came with a release of creative potentials in product design and delivery in the financial sector. The spread and advancement in business deals resulted in increased demand for the use of various financial solutions or instruments. These instruments addressed various financial transactions that covers fund mobilisation, settlement of debt obligation, outright payment for goods and services, financing and refinancing; all of which are floated either in one or both of the two platform of the capital or money market. The process of securitization creates these instruments that are deployed to address these varied financial needs.

Securitization involves the pooling of various types of contractual debts such as residential mortgages, commercial mortgages, auto loans or credit card debt obligations and other such assets, and selling said consolidated debt as bonds, pass-through securities, or collateralized mortgage obligations (CMOs), to various investors. The principal and interest on the debt, underlying the security, is paid back to the various investors regularly. Two classic examples of this arrangement are available. First is the mortgage backed securities (MBS) that derives from mortgage receivables; and the second is the asset backed securities (ABS) that derives from the cashflow or of receivables of other types of assets.

Securitization has been in high use accounting for a significant size of the financial market. However, its complexity tends to limit the ability of investors to monitor risk. The reason for this is the existence of competitive securitization with multiple securitizers. A case in point is the US sub-prime mortgage crisis in which the private, competitive mortgage securitization is believed to have played an important role.

It is of interest to note that the bits of pools of securitized assets serves as a mitigant to the credit risk of individual borrowers. Unlike general corporate debt, the credit quality of securitised debt changes as a result of its volatility which in turn depends on time and structure. If the transaction is properly structured and the pool performs as expected, the credit risk of all tranches of structured debt improves; if improperly structured, the affected tranches may experience dramatic credit deterioration and loss.

### DEVELOPMENT OF SECURITISATION

Securitization took its roots from the 18th century in the US, and the early examples of mortgage-backed securities were the farm railroad mortgage bonds of the mid-19th century which contributed to the panic of 1857. The U.S. Department of Housing and Urban Development in 1970 created the first modern residential mortgage-backed security. Over the years the market has grown to an estimated outstanding of \$10.24 trillion in the United States and \$2.25 trillion in Europe as at the 2nd quarter of 2008. In 2007, ABS issuance amounted to \$3.455 trillion in the US and \$652 billion in Europe. Whole Business Securitization (WBS) arrangements first appeared in the United Kingdom in the 1990s, and became common in various Commonwealth legal systems where senior creditors of an insolvent business effectively gain the right to control the company

Modern securitization took off in the late 1990s or early 2000s, following the innovative structures implemented across the asset classes, such as UK Mortgage Master Trusts, a concept imported from the US Credit Cards, Insurance-backed transaction, such as the ones implemented by the insurance securitization guru Emmanuel Issanchou, or even more esoteric asset classes such as the securitization of lottery receivables. Starting in the 1990s with some earlier private transactions, securitization technology was applied to a number of sectors of the reinsurance and insurance markets including life and catastrophe. This activity grew to nearly \$15bn of issuance in 2006.

The Government National Mortgage Association (GNMA or Ginnie Mae) sold securities backed by a portfolio of mortgage loans. To facilitate the securitization of non-mortgage assets, businesses substituted private credit enhancements. First, they over-collateralised pools of assets; shortly thereafter, they improved third-party and structural enhancements. In 1985, securitization techniques that had been developed in the mortgage market were applied for the first time to a class of non-mortgage assets like automobile loans. A pool of assets second only to mortgages in volume, auto loans were a good match for structured finance; their maturities, considerably shorter than those of mortgages, made the timing of cash flows more predictable, and their long statistical histories of performance gave investors confidence.

## MARKET UPDATE

	15/01/13	15/12/13	11/04/14
Naira/US\$	154.1	155.2	155.75
Brent, US\$/BBL	109.78	107.84	109.9
COCOA, US\$	1487.82	2685.47	2760.56
MPR%	12.00	12.00	12.00
INFLATION RATE %	10.3	7.9	7.7
MORTGAGE RATE %	22.0	23.0	23.0

## STOCKS CONSTITUTING GMA INDEX

STOCKS	31/12/13 Price (N)	11/04/14 Price (N)	%Change in Price
OANDO	12.00	15.95	-34.19
GTBANK	23.00	27.12	-0.37
OKOMU	41.00	42.00	-4.55
STANBIC	11.00	20.45	-4.22
DANGSUGAR	5.98	9.85	-15.81
FIDSON	1.08	2.95	4.66
TRANSCORP	1.03	3.84	-11.72
CCNN	5.30	9.21	-21.62

	PRICE(N) 31/01/14	NAV (N) 11/04/14
UHOREIT	50.00	55.58
UPDCREIT	10.00	10.17

Index	31/12/13	11/04/14	% Change
NSE ASI	41,329.19	39,083.66	-7.85
GMA Index	1.50	1.40	-7.09

### Source: CBN, SEC and NSE

In nominal terms, over the last ten years, (1995–2004,) ABS amount outstanding has grown about 19 percent annually, with mortgage-related debt and corporate debt each growing at about 9 percent. Gross public issuance of asset-backed securities remains strong, setting new records in many years. In 2004, issuance was at an all-time record of about \$0.9 trillion. Recently, securitization has been proposed and used to accelerate development of solar photovoltaic projects. For example, Solar City offered the first U.S. asset backed security in the solar industry in 2013.

### HOW DOES IT WORK?

The originator initially owns the assets engaged in the deal. This is typically a company looking to raise capital, restructure debt or otherwise adjust its finances. Under traditional corporate finance concepts, such a company would have three options to raise new capital - raise a loan, issue bond, or by issuance of stock. However, stock offerings dilute the ownership and control of the company, while loan or bond financing is often prohibitively expensive due to the credit rating of the company and the associated rise in interest rates.

The consistently revenue-generating part of the company may have a much higher credit rating than the company as a whole. For instance, a leasing company may have provided \$10m nominal value of leases, and it will receive a cash flow over the next five years from these. It cannot demand early repayment on the leases and so cannot get its money back early if required. If it could sell the rights to the cash flows from the leases

to someone else, it could transform that income stream into a lump sum today, in effect, receiving today the present value of a future cash flow. Where the originator is a bank or other organization that must meet capital adequacy requirements, the structure is usually more complex because a separate company is set up to buy the assets.

A suitably large portfolio of assets is "pooled" and transferred to a "special purpose vehicle" or "SPV" (the issuer), a tax-exempt company or trust formed for the specific purpose of funding the assets. Once the assets are transferred to the issuer, there is normally no recourse to the originator. The issuer is "bankruptcy remote", meaning that if the originator goes into bankruptcy, the assets of the issuer will not be distributed to the creditors of the originator. In order to achieve this, the governing documents of the issuer restrict its activities to only those necessary to complete the issuance of securities.

Accounting standards govern when such a transfer is a sale, a financing, a partial sale, or a part-sale and part-financing. In a sale, the originator is allowed to remove the transferred assets from its balance sheet: in a financing, the assets are considered to remain the property of the originator. Because of these structural issues, the originator typically needs the help of an investment bank (the arranger) in setting up the structure of the transaction.

### PROCESS OF ISSUANCE

To be able to buy the assets from the originator, the issuer SPV issues tradable securities to fund the purchase. Investors purchase the securities, either through a private offering (targeting institutional investors) or on the open market. The performance of the securities is then directly linked to the performance of the assets. Credit rating agencies rate the securities which are issued to provide an external perspective on the liabilities being created and help the investor make a more informed decision.

In transactions with static assets, a depositor will assemble the underlying collateral, structure the securities and work with the financial markets to sell the securities to investors. The depositor typically owns 100% of the beneficial interest in the issuing entity and is usually the parent or a wholly owned subsidiary of the parent which initiates the transaction. In transactions with managed (traded) assets, asset managers assemble the underlying collateral, help structure the securities and work with the financial markets in order to sell the securities to investors.

Some deals may include a third-party guarantor which provides guarantees or partial guarantees for the assets, the principal and the interest payments, for a fee.

The securities can be issued with either a fixed interest rate or a floating rate under currency pegging system. Fixed rate ABS set the "coupon" (rate) at the time of issuance, in a fashion similar to corporate bonds and treasury bills. Floating rate securities may be backed by both amortizing and non-amortizing assets in the floating market. In contrast to fixed rate securities, the rates on "floaters" will periodically adjust up or down according to a designated index, such as the Nigerian Interbank Offered Rate (NIBOR). The floating rate usually reflects the movement in the index plus an additional fixed margin to cover the added risk.

### CREDIT ENHANCEMENT

Unlike conventional corporate bonds which are unsecured, securities generated in a securitization deal are "credit enhanced", meaning their credit quality is increased above that of the originator's unsecured debt or underlying asset pool. This increases the likelihood that the investors will receive cash flows to which they are entitled, and thus causes the securities to have a higher credit rating than the originator. Some securitizations use external credit enhancement provided by third parties, such as surety bonds and parental guarantees (although this may introduce a conflict of interest). Credit enhancements affect credit risk by providing more or less protection to promised cash flows for a security. Additional protection can help a security achieve a higher rating, lower protection can help create new securities with differently desired risks, and these differential protections can help place a security on more attractive terms.

### CONCLUSION

Securitisation in its simplest form is straightforward and beneficial. For example, a firm expecting lots of monthly payments from customers who have taken out financing can get investors to fund its business more cheaply by selling them its claim to those payments. A bank on the receiving end of mortgage repayments or other receivables can do something similar: put the loans together and sell them, or use them as collateral to get funding, which it can then use to issue more loans. This boosts both credit and growth.

There is no limit to securitisation. It is only limited by the creativity stretch of the financial adviser, and of course the risk appetite of investors. The Nigerian economy is on the growth momentum. Investors are hard pressed for alternative investment widows. The onus is therefore on the market operators to create definitive products to track the investible funds, and deliver them appropriately.

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