

## Securitization

### HIGHLIGHTS

- A form of off-balance sheet financing which involves the pooling of financial assets.
- Risk transfer mechanism that allows loan originators to optimize balance sheet management.
- Allows highly rated securities to be created from less credit worthy assets.
- Can be in local or foreign currency, depending on client needs.
- A rapidly growing asset class with proven benefit for emerging market borrowers.

### PRODUCT DESCRIPTION

Securitization is a form of financing which involves the pooling of financial assets and the issuance of securities that are repaid from the cashflows generated by these assets. This is generally accomplished by a true sale of the assets to a bankruptcy remote vehicle which finances the purchase through the issuance of bonds, which are backed by the future cashflows of the asset pool. This achieves the outcome of creating a class of securities for which the underlying risk is independent from that of the originating institution, and generally of a higher credit quality.

In order to obtain the lowest all-in cost of financing for the asset originator, the risk inherent in the asset pool is often structured to create two or more layers of risk. These layers are often referred to as tranches. Typically, the expected loss on the portfolio is carved out into a 'junior' (also referred to as 'equity') tranche which is retained by the originator. Requiring the originator to fully absorb the initial losses helps to mitigate the moral hazard which would otherwise be present if one entity were to originate the portfolio, but not have a stake in its eventual performance.

The next tranche of risk is often referred to as 'mezzanine,' which is generally structured to absorb those losses that are not necessarily expected, but which may reasonably occur if performance of the portfolio is worst than anticipated. With the proper amount of subordination, derived from the junior and mezzanine tranches, it is then possible to structure a highly rated 'senior' tranche which is generally deemed to comprise relatively little risk. If adequately structured, this senior tranche achieves a risk/reward combination sufficient to attract institutional investors.

### BRIEF HISTORY

Securitization took off as an asset class in the mid-1980s. By late 2004, this asset class had grown to represent 31% of the US\$23 trillion US bond market, with home mortgages representing the majority of those securitized assets. Although securitization in Europe took longer to establish itself, there has been a ten-fold increase in securitization issuance, from US\$50bn to US\$500bn between 1998 and 2003.

In the emerging markets, securitization has been growing quickly. Initially, most of the transactions involved the

securitization of future offshore cashflows derived from exports and remittances. Such structures, generally referred to as 'future flow' transactions, are driven by the need for borrowers to raise relatively cheap cross-border financing. This is achieved by mitigating the currency transfer risk which would otherwise be present in their corporate borrowings. More recently, as many developing countries have begun adopting the legal and regulatory reforms necessary for the domestic issuance of securitization, the bulk of activity has shifted to local markets. Although future flow transactions do play a role in the local markets, the securitization of existing assets has seen the largest growth.

### WHEN IS IT APPLICABLE?

Securitization is most appropriate for a company that is seeking balance sheet management, or a company with a specific pool of assets which is better than its overall credit quality. In principle, any asset pool with predictable cash flows can be securitized, even those which are non-performing, as long as the timing and amount of recovery is predictable. The most common assets for securitization include: mortgages, credit cards, auto and consumer loans, corporate debt, export receivables, and offshore remittances.

### IFC's ROLE

IFC participates in domestic and cross-border securitizations, generally by investing in the mezzanine portion of risk. This investment generally takes the form of either a partial guarantee on the senior tranche, or a partial guarantee on the investment vehicle, and can be denominated in the client's currency of choice, including local currency. As the guarantee is tailored to specific transactions, IFC gets involved early in the process, taking on a lead role in structuring the risk which it will retain. Investments are also made in the longest tranches of a deal to help clients access longer-term funding. In addition, IFC provides liquidity support, currency and interest rate swaps, and warehouse line facilities to build up asset pools for securitization.

### BENEFITS

- Alternative form of funding
- Market access
- Balance sheet management
- Risk transfer
- New investor base
- Potentially lower cost of funding
- Long-term funding
- Potential capital relief
- Capital market development

