

Assalamu alikum
&
Welcome

Presentation on
Fundamental Concepts and Issues
of
Asset Securitization

Presented by



AIMS of BANGLADESH LTD.

September 25, 2003

ABOUT AIMS

- /// **AIMS is the first and till date the only approved Asset Management Company in Bangladesh.**
- /// **AIMS has the rare distinction of designing, structuring and floating the first mutual fund in Bangladesh under private initiative (AIMS First Guaranteed Mutual Fund)**
- /// **AIMS is the Asset Manager of the 'Grameen Mutual Fund One' sponsored by the Grameen Bank.**
- /// **AIMS has structured the proposed securitization of micro-credit receivables of BRAC, the largest NGO in the world, and is also to act as the Trustee of the SPV.**

ABOUT AIMS contd...

- /// AIMS is exploring the prospects of securitizing microcredit receivables of the Grameen Bank and receivables of some other leading Nonbanking Financial Institutions.**
- /// To realize the vision of developing an active debt market in the country, AIMS is working in close concert with leading local and multilateral institutions**
- /// AIMS is a research and analysis oriented institution and disseminates information and findings through regular local and international publications.**

INTRODUCTION TO SECURITIZATION

- /// **A dominant and rapidly expanding means of finance.**
- /// **'Securitization,' 'Asset Securitization,' 'Structured Finance' are same.**
- /// **Securitization refers to a company's use of cash flows from its assets to raise funding.**
- /// **The term 'Securitization' specifically refers to the issuance of securities backed by such cash flows.**

INTRODUCTION TO SECURITIZATION contd...

- /// Genuine reduction of financial costs and lower risk investment.**
- /// The basic driving force of the expansion of securitization lies on infinite possibility of innovative structuring.**

DEFINING SECURITIZATION

- /// Pooling of assets, which have an income stream
- /// Repackaging of those assets, in the form of marketable securities, for sale to investors.
- /// The securities are secured (or collateralized) by the assets themselves
- /// More attractive to investors than the underlying assets
- /// Any asset generating regular predictable income may be securitized

DEFINING SECURITIZATION contd...

- /// Knowledge of particular assets vis-à-vis knowledge of the originator**
- /// Payment must not be materially impaired by the financial behavior of the related originator or any of its affiliates**

MAIN FEATURES OF SECURITIZATION

- /// Isolation of the assets
- /// Creation of Special Purpose Vehicle (SPV)
- /// Creation of securities
- /// Sensitive to regulatory guidelines and other arbitrary limits
- /// Better handling of risk
- /// Better risk-return alignment
- /// Limited recourse to the Originator

MAJOR PARTIES OF SECURITIZATION

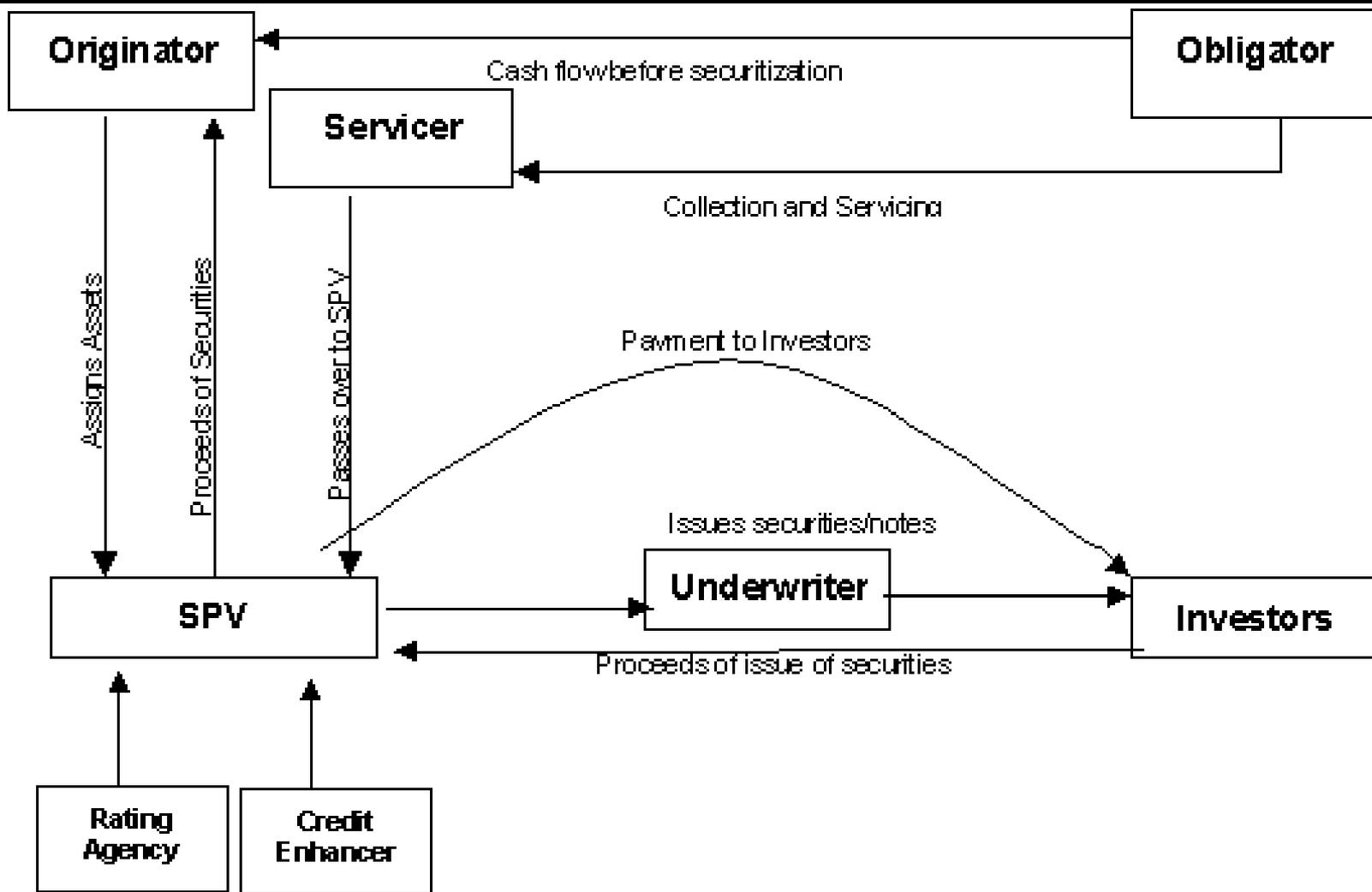
- /// Originator
- /// SPV
- /// Obligator
- /// Servicer
- /// Investment Advisor
- /// Underwriter
- /// Investors

MAJOR PARTIES OF SECURITIZATION contd...

Functions of Investment Advisor

- **Analyzing the cash flow and splitting into different tranches**
- **Arrange completion of legal formalities and documentation**
- **Devising appropriate marketable securities**
- **Arrange rating of the securities**
- **Arrange credit enhancement**
- **Marketing and placement**
- **At times acts as the Trustee of the SPV**

ORGANIZATION OF SECURITIZATION



WHY SECURITIZATION

Benefits to originator

- /// Replishable and consistent source of funding
- /// Lower cost
- /// Ability to sell assets readily at profit
- /// More efficient use of capital
- /// Alternative investor base – institutional and retail
- /// Risk management by risk transfers
- /// Matching of assets and liabilities
- /// Escapes tax based on interest

WHY SECURITIZATION contd...

Benefits of investors

- /// High yields on rated securities**
- /// Liquidity**
- /// Enhanced diversification**
- /// Potential trading profits**
- /// Better risk-return alignment**

WHY SECURITIZATION contd...

Benefits to capital market/investment banks

- /// New product line**
- /// Continuous flow of originations and fees**
- /// Trading volumes and profits**
- /// Potential for innovation and market expansion**

SECURITIZABLE ASSETS AND ISSUERS

Assets that can be securitized

- /// Existing assets in the form of long term receivables
- /// Existing assets in the form of short term receivables
- /// Existing physical assets in the nature of current assets
- /// Existing physical assets in the nature of fixed assets
- /// Future receivables

SECURITIZABLE ASSETS AND ISSUERS contd...

Qualifications

- /// Reasonable predictability of the cash flows**
- /// Standardized contracts**
- /// Diversified assets**
- /// Legal possibility of assignment**

SECURITIZABLE ASSETS AND ISSUERS contd...

Typical Issuers of Securitization

- /// Mortgage financiers, including housing finance companies**
- /// Banks and other finance companies**
- /// Leasing companies**
- /// Credit card companies**
- /// Insurance companies**
- /// Public utility agencies**
- /// Aviation companies**
- /// Governments**

SECURITIZABLE ASSETS AND ISSUERS contd...

Investors of Securitized Issues

- /// Banks and insurance companies**
- /// Investment companies**
- /// Government agencies**
- /// Corporations**
- /// High net-worth individuals**

STRUCTURING

Basic requirements for securitization

- /// Standardized contracts
- /// Grading of risk
- /// Database of historic statistics
- /// Standardization of applicable laws
- /// Standardization of servicer quality
- /// Reliable supply of quality credit enhancers
- /// Computers to handle complexity of analysis

Two steps to effective structuring

- Receivable analysis
- Credit Enhancement

STRUCTURING contd...

Receivable Analysis

- /// Identifying assets to be securitized and valuing their quality.**
 - origination and terms of the loans.**
 - representation and warranties concerning compliance with lending laws and the characteristics of the pool sold.**
 - maximum original loans maturity, minimum interest rate.**
 - payment history, maximum number of days any receivable is delinquent.**

STRUCTURING contd...

Receivable Analysis contd...

- /// The interest on the receivables must be adequate to cover the investor coupon, servicing fee, trustee fee and any other expenses for which the issuer is liable**
- /// Identifying the types of the receivables that dictate security structure**
 - Installment Contracts**
 - Revolving Line of Credit**
- /// Analysis of the seller's collection performance**

STRUCTURING contd...

Credit enhancement

/// Credit quality is the prime reason of popularity of asset-backed security (ABS) in the developed world and hence credit enhancement is considered as the single most important issue in any ABS.

/// Issues for designing an effective and adequate credit enhancement scheme:

- cash flow pattern of the receivables**
- representation of sellers own portfolio of receivables**
- geographic composition of the borrowers**
- borrower profile**
- loan size**
- original loan term**
- loan coupon**

CREDIT ENHANCEMENT MECHANISM

- /// Yield Spread
- /// Letter of Credit
- /// Subordination
- /// Guarantee
- /// Recourse
- /// Reserve Fund
- /// Overcollateralization

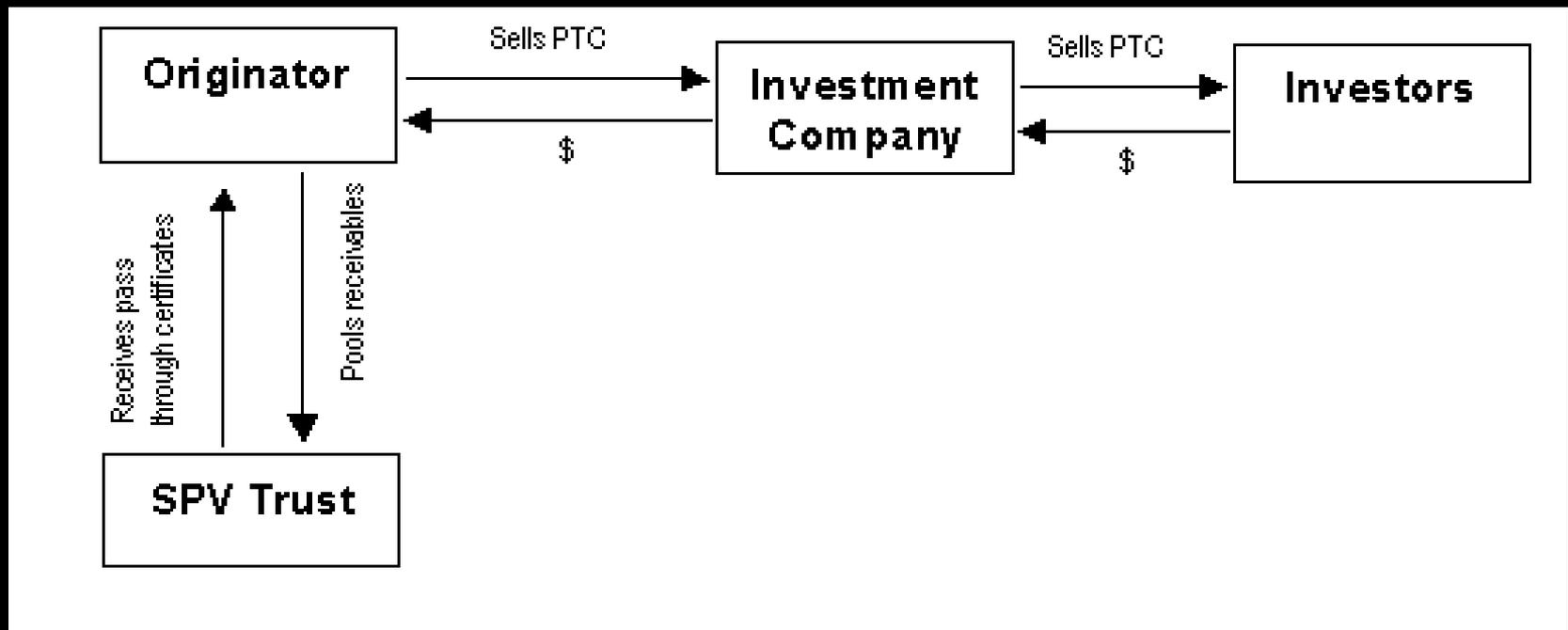
STRUCTURES OF SECURITIZATION

Pass-through structure

- /// Payments on the receivables are directly passed through the SPV Trust to the holders of the pass-through certificates without any reconfiguration of the cash flows.
- /// The pass-through certificates represent undivided ownership interests in the receivables pooled.
- /// Usually the structure is preferred when the SPV Trust is a tax-exempt entity.
- /// Result into creation of erratic cash flows.
- /// Single maturity

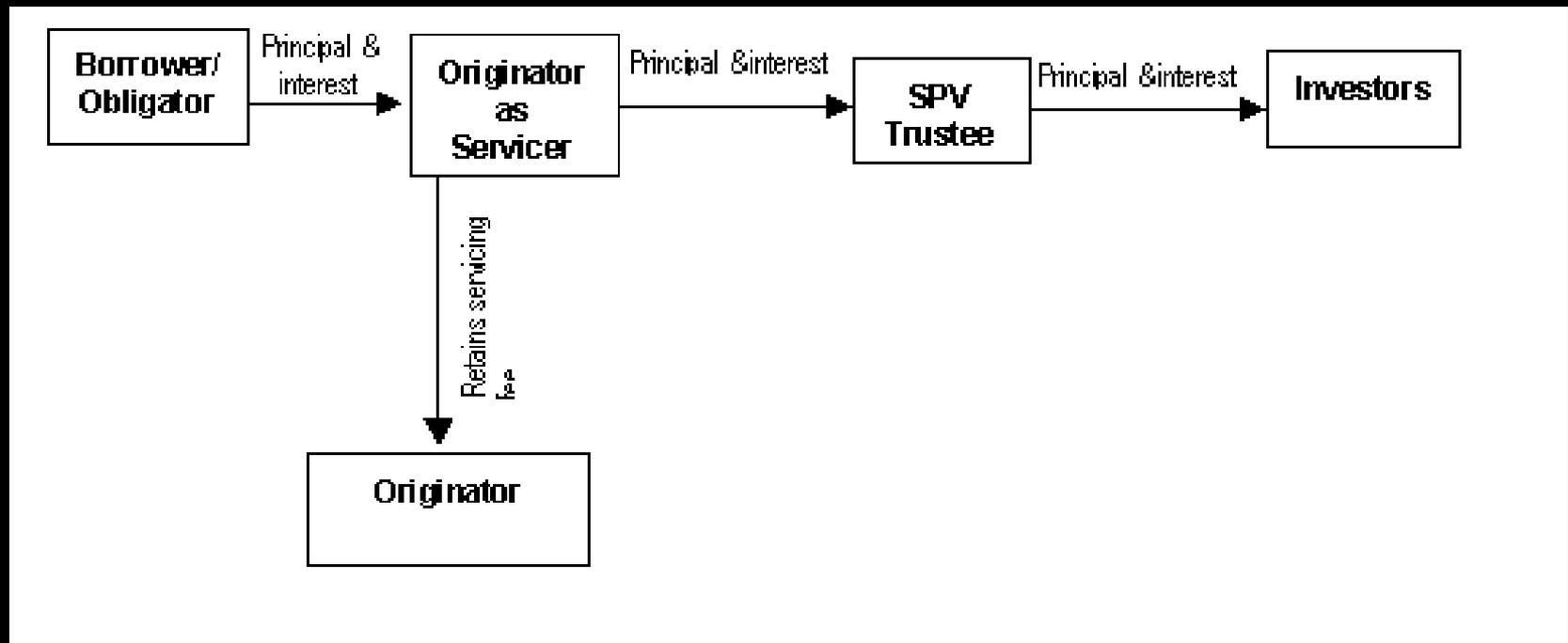
STRUCTURES OF SECURITIZATION contd...

Typical Pass-Through Structure



STRUCTURES OF SECURITIZATION contd...

Pass-Through payment stream



STRUCTURES OF SECURITIZATION contd...

Pay-through structure

- /// Securities are structured in the form of debt of the issuer, rather than the ownership interests.**
- /// Permits the issuer to restructure or reconfigure receivables' cash flows.**
- /// The SPV reinvests the surpluses in other securities (specified or guaranteed).**
- /// Offer a range of investment maturities to interested investors, which are structured to qualify as debt under law.**

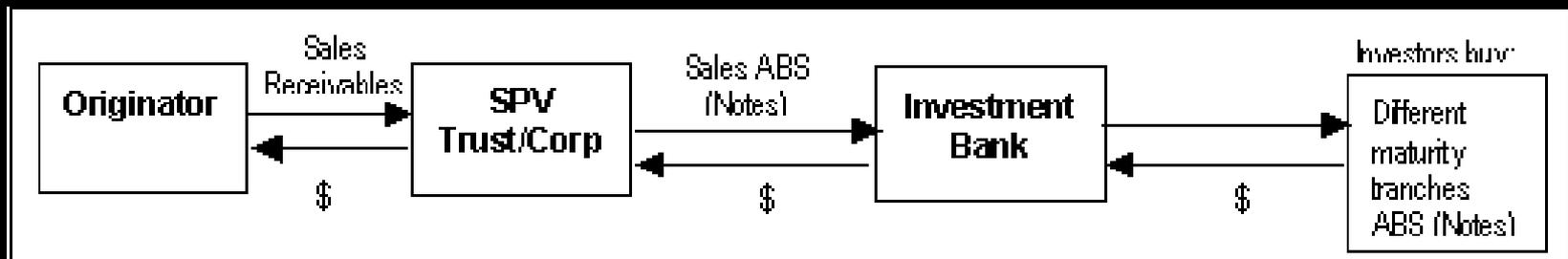
STRUCTURES OF SECURITIZATION contd...

Pay-through structure contd...

- /// **Permits the SPV to play the yield curve to permit the lowest possible weighted average coupon.**
- /// **Economic differences are created between the receivables collateral and the debt securities; difference may include: payment frequencies, optional call provisions on the debt securities, maturity, interest schedules, etc.**
- /// **Usually the structure is preferred when the SPV is taxable.**
- /// **Since interest paid by an issuer of debt securities is fully tax-deductible, SPV are able to minimize taxation.**
- /// **Cash flows are stable.**

STRUCTURES OF SECURITIZATION contd...

Typical Pay-Through Structure



SECURITIZATION VS. BORROWING

<i>Securitization</i>	<i>Borrowing</i>
Securitized instruments are liquid	Loans are illiquid
Originator transfers/sales its assets	Originator assumes normal monetary obligation
Market determines the value of the assets (the collateral)	Collateral valuation is subjective and periodic
Third parties – rating agencies and enhancers – assess risk	Originator assess risk
Originator transfers its claims against debtors	No connection with the debtor of the originator
Originator's operating costs low	Originator's operating costs high
Investors do not suffer from the bankruptcy of the originator	Investors may suffer from the bankruptcy state of the originator
Investors may suffer a loss in case of default of the original borrowers	Investors do not suffer as their claim is against the originator not on the performance of the borrowers

MAJOR LEGAL CONCERNS

Transfer of Assets

- /// The principal legal concern for securitization pertains to the characterization of the transfer of assets to the SPV Trust as 'True Sale'.
- /// 'True Sale' attempts to cause such transfers to eliminate the ability of the originator to call on the transferred assets in its own bankruptcy.

MAJOR LEGAL CONCERNS contd...

Recourse to the Originator

- /// Absolute recourse to the originator may hamper the 'True Sale' nature of the transfers.**
- /// Transfer with 'recourse for collectibility' may be accepted as true sale by the bankruptcy court.**

MAJOR LEGAL CONCERNS contd...

Recourse to the Originator contd...

/// In a sale with recourse for collectibility:

- **the buyer's return is tied directly to the payment terms of the underlying asset;**
- **upon liquidation, the buyer's interest in proceeds is not limited to the investment plus a predetermined rate of return that is unrelated to the underlying assets;**
- **only the buyer's interest, not the seller's, is affected by post purchase changes in the asset's market value; and**
- **normally, the seller would not have a right to substitute the asset purchased with a new asset.**

MAJOR LEGAL CONCERNS contd...

Recourse to the Originator contd...

- /// **Transfer with 'economic recourse' may not be adjudged as sale, where recourse for the buyer's return was fixed, calculated in advance, at a rate unrelated to the payment terms of the underlying asset.**

MAJOR LEGAL CONCERNS contd...

Bankruptcy-remoteness of SPV

- /// Restrictions on objects and power**
- /// Debt limitations**
- /// Independent directors/trustee**
- /// No merger or acquisition etc.**
- /// Separateness covenants**

MAJOR LEGAL CONCERNS contd...

Bankruptcy-remoteness of SPV contd...

/// Separateness covenants

- maintain books and records separate from any other entity**
- maintain its accounts separate from any other entity**
- not commingle assets with those of any other entity**
- conduct business in its own name**
- pay its own liabilities out of its own funds**

ISSUES FROM BANGLADESH VIEWPOINT

Cost Concerns

- /// **Securitizing assets is expected to be less costly than borrowing or issuance of other debt instruments.**
- /// **The registration fee has been drastically reduced to Tk 2,500.**
- /// **Since securitized instruments shall be issued by SPV Trust, which is not subject to Statutory Liquidity Reserve (SLR), cost will be much lower.**
- /// **Firm commitment underwriting may be replaced with 'Best Effort' underwriting or underwriting may be forgone to reduce cost.**
- /// **Because of identified quality assets and predictable cash flow, coupon of securitized debt issues shall be less than normal debt instrument.**

ISSUES FROM BANGLADESH VIEWPOINT contd...

Additional Steps Towards Reducing Cost

- /// Assignment or Transfer Agreements can be made as supplements to the Trust Deed requiring no additional stamp duty and repeated filing to the Registrar's Office.**
- /// AIMS also suggest creating the SPV Trust as a 'not-for-profit' entity for getting tax-exempt status.**
- /// AIMS further suggests that the NBFIs shall not go for public issue in their several initial tranches, which will save their issue cost including underwriting commission to a great extent.**

ISSUES FROM BANGLADESH VIEWPOINT contd...

Additional Steps Towards Reducing Cost

- /// AIMS also holds that a conduit SPV structure, pooling of assets from different NBFIs, may also reduce issue cost while enhancing credit quality of the securitized instruments.**
- /// Lower yield due to high quality.**
- /// Expected SLR status will further reduce coupon than usual.**

ISSUES FROM BANGLADESH VIEWPOINT contd...

Market Demand for Debt Instruments

- /// **Considering the current size and nature of the stock market, investors' understanding of investment risk, necessity for even cash flow, gradual perception of constructing balanced and efficient portfolio, we can reasonably expect debt instruments to have a big market in a period of two to three years.**
- /// **The unpleasant experience of the short-term investments in the stock market propped the investors to look into long-term investment horizon further brightening the prospect of the debt market.**
- /// **There exists a strong demand of debt instruments among the banks and insurance companies**
- /// **If the SLR status of the instruments is obtained, the market will expand to a great extent**
- /// **A World Bank study also ascertained adequate investor appetite for quality debt instruments.**

ISSUES FROM BANGLADESH VIEWPOINT contd...

Ensuring Marketability

- /// In early stages, the Trustee or any other institution can be appointed as the transferring agent, who shall act as broker and also maintain the transfer register.**
- /// International finance agencies can facilitate the marketability through providing support taking opposite position of a transaction, if any counter party is not found. Liquidity facility may be an alternative option.**
- /// Stock Exchanges of Bangladesh are capable of enlisting debt instruments.**

ISSUES FROM BANGLADESH VIEWPOINT contd...

Legal Framework

- /// Although we don't have any independent law for issuance of debt or securitized instruments, there is no impediment for such issuance under the common laws of the country and Public Issue Rules or the Companies Act.**
- /// Debt issuance including the securitized structure are not in conflict with any provisions of the country's Trust Law, Bankruptcy Act, the Securities Act, the Registration Act, the Negotiable Instrument Act, or any other pertinent legislation.**
- /// SPV Trust may receive bankruptcy-remote status within existing legal framework.**
- /// The SPV Trust could also be bankruptcy proof if there are no fraudulent transfers and transactions.**
- /// There exists a gray area as regards to regulatory authority on debt issues between Bangladesh Bank and the Securities and Exchange Commission.**

ISSUES FROM BANGLADESH VIEWPOINT contd...

Credit Rating

- /// **Credit rating is regarded by many concerned quarters as a prerequisite for issue of debt instruments.**
- /// **Given the local culture and practice, rating may not be regarded as prerequisite for local marketing.**

Accounting & Auditing

- /// **Accounting of debt issue/securitization transaction should be maintained as per International Standards of Auditing.**
- /// **Major local auditing firms opined that sale of assets for securitization shall receive off-balance sheet treatment since the recourses may be viewed as separate transaction.**

ISSUES FROM BANGLADESH VIEWPOINT contd...

Balance Sheet Effect of Selling of Good Loans

- /// As per convention, the Originator shall sell a subset of assets replicating the credit quality of the asset-portfolio of the Originator.**
- /// Securitization shall enhance the capacity of the originator to create more good quality loans, which may even improve the balance sheet quality of the issuing institution.**

ISSUES FROM BANGLADESH VIEWPOINT contd...

Issues to be Resolved

- /// Developing yield curve and benchmarks through rationalization of the interest rate structure, specially for the government borrowing and saving schemes.**
- /// Pro-rata allocation of depreciation for mid-year assignment or sale, which is necessary for fair adjudication without penalizing the NBFIs who is selling its lease assets.**
- /// Foreclosure prospects, in absence of any dedicated law, though the Money Loan Court Act and Bankruptcy Act may have some relevance.**
- /// Establishment of credit rating agencies.**

Securitization of Micro-Credit Receivables of BRAC: First Securitization Attempt in Bangladesh

Transaction

- /// BRAC is the largest NGO of the world engaged in micro-credit finance with an outstanding recovery history of 98 percent and no pre-payment history/option.**
- /// The SPV is being established as a not-for-profit Trust through executing a Trust Deed and registering the same with the registrar's office.**
- /// The SPV shall be an open-ended trust, which will float securitized bonds with different nature and maturity for different pool of assets from time to time.**
- /// The first securitized bonds is planned to be floated for about Tk100 million as first tranche issue of a total target of Tk1.0 billion.**

Securitization of Micro-Credit Receivables of BRAC: First Securitization Attempt in Bangladesh contd...

- /// Separate Transfer Agreement shall be executed for conveyance of each pool of assets to be securitized. Such agreements shall be the integral part of the Trust Deed requiring no repeated registration.**
- /// BRAC, the Originator, shall be appointed as the Servicing Agent.**
- /// According to the servicing agreement, the Servicing Agent shall be responsible to collect a predetermined amount of receivables, or shall be obliged to compensate the Trust in case of any shortfall of recovery.**
- /// In effect, BRAC will provide recourse for collectibility to the investors not as the originator, but as servicing agent of the Trust.**

Securitization of Micro-Credit Receivables of BRAC: First Securitization Attempt in Bangladesh contd...

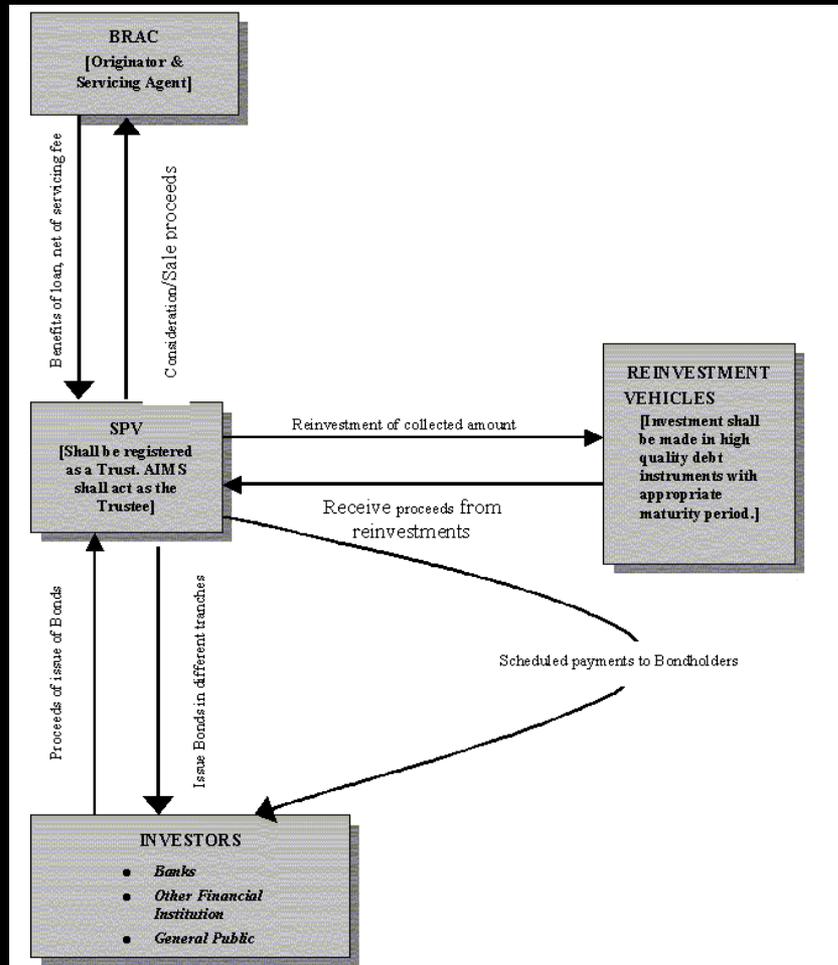
- /// IFC has shown interest to create a facility for the BRAC securitized issues towards creating a secondary market for the instruments.**
- /// AIMS of Bangladesh, the advisor, is to act as the Trustee of the SPV Trust.**
- /// Microcredit receivables of a number of carefully selected Operation Centers shall be sold for the purpose of the securitization.**

Securitization of Micro-Credit Receivables of BRAC: First Securitization Attempt in Bangladesh contd...

Structure

- /// Simple pay-through structure with a single tranche issue has been contemplated for the securitization deal.**
- /// Maturity of the first issue shall range between 15 to 24 months.**
- /// The prevailing Bank Rate (with or without premium) and the Agrani Bank Industrial Bond may be used as the floor and ceiling coupon benchmark for the initial tranche of issues.**

Structure of BRAC Securitized Bond



thank you
for your time