



SECURITIZATION

Special Report

Securitization is a type of structured finance transaction through which a corporation in need of funds transfers its specific asset or pool of assets, usually difficult to be liquidated, to a special purpose vehicle (SPV), which then issues debt instruments secured by the cashflows from or the value of those assets, in order to raise funds. The securitization process entails rearrangement (structuring), by the packager, of certain assets in the form of securities, supported by a well-defined and isolated cashflow stream, so that the assets become more salable to the investors. The cashflow stream may be related either to assets that already exist at the time of issuance or to the assets the origi-

nator is expected to generate during the term of securities. The former is an asset-backed securitization (ABS) and the latter is future flow securitization (FFS).

This unique mode of financing traces its origins back to the early seventies in the United States where need arose to finance residential mortgages, while in Asian economies, like Japan, Hong Kong, China and Thailand, securitization gained recognition during the nineties. More recently Asian companies have begun to securitize future flows from exports, toll roads and international credit card settlements. Over the span of more than three decades, a wide range of assets including utility receivables, oil and gas contract receivables, consumer loans, and

Major Asset Backed Products

Mortgages: Fixed contractual nature; consistent documentation and approval standards.

Auto Loans: Fixed rate; level payment instruments; standardized documentation and processes; strong underlying asset value.

Trade Receivables: Non-yielding, sold at discount that imputes a yield that also adjusts

credit enhancement. Originators are generally manufacturing and service companies.

Lease Receivables: Assets with predictable cashflows.

Future Flow Securities: Usually backed by future export receivables, international telephone call settlements, international credit card settlements, airline ticket and oil & gas receivables.

insurance policy holder loans have been securitized.

Pakistan was a little late in catching up with this financing mode. The State Bank of Pakistan (SBP) issued guidelines for banks, development financial institutions (DFIs) and other parties performing various roles in securitization in November 2002. This was shortly followed by a couple of securitization transactions during FY2003. One of them was a FFS transaction of oil and gas receivables of Orient Petroleum Inc. (Pakistan branch) and the other transaction was by Paktel Limited. In the years to come, securitization is expected to gain momentum as the corporate and investor market becomes more receptive to novel forms of structured financing.

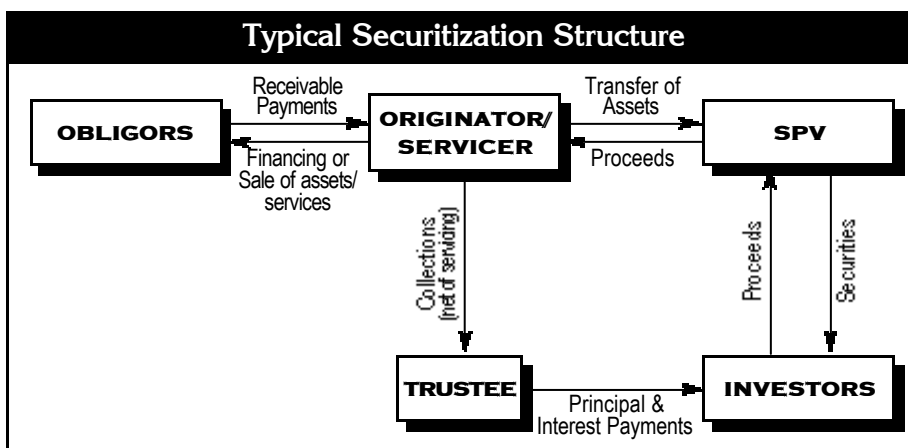
Structure of Securitization

A typical securitization structure consists of an originator whose business gives rise to the receivables that collateralize an asset-backed structure. The collection of receivables is done by the servicer who also takes appropriate enforcement actions, when necessary, to pursue the pay-

ments. The originator's familiarity with the receivables and the obligors makes it the preferred party to service the receivables. However, in case of the originator

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having weak credit standing, it is likely that some third party will be required to fill in the role of a servicer. The receivables are sold to a bankruptcy remote legal entity, the SPV, that is established for the specific purpose of facilitating the financing with very limited scope of operations so that its own business and financial risks are limited. A trustee is also featured in the transaction to safeguard the investors' interests and the supporting facilities and the entitlements of beneficiaries for their payments. Professional advisors such as arrangers, legal counsel and external auditors also add support to the transaction while a rating agency assesses the risk in the transaction which ultimately determines the cost of funds for the originator. The resultant securities issued by the SPV are bought by investors. Finally, regulators also play a vital role in ensuring that securitization does



not undermine prudential supervision especially in respect of exposure limits.

Benefits of Securitization

A number of incentives offered by securitization renders it attractive compared to other methods of funding. With the right assets, credit enhancement and securitization terms, the securities issued may have a better credit rating than that of the originator. This is especially true in case of ABS, where performance of the assets is unhindered by the risk of originator's discontinued operations. A better credit rating usually leads to lower financial cost on the securities issued, a broader investor-base and greater investor receptivity to longer maturities. It also provides an opportunity to an originator with a below investment-grade rating to issue investment-grade securities. In case of high yielding portfolios/pools, there is profit on sale, as the IRR on the pool is higher than coupon on ABS. Hence there is a boost to the bottom-line and EPS in the year of securitization.

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yielding assets for redeployment at higher rates. Moreover, securitization generates cash without any addition to the originator's borrowings and without impacting the debt-leverage of the originating company. Banks and DFIs who are fully exposed to some corporates or groups can do more business with them without violating regulations by securitizing their

existing exposure.

Securitization Costs & Expenses

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tions deal with them, all of the above costs may be recognized in the financial statements of either the originator or the SPV, however, in both cases the eventual economic onus is on the originator. Generally, the tax treatment rendered to them will be the deciding factor.

Front-end expenses include fees for various functions like underwriting, legal counseling, credit rating, transaction marketing etc. These have to be paid at the beginning of the securitization transaction.

Running costs pertain to the operations and management of the SPV. The most important component of these costs is the servicing of the outstanding obligations to the investors. Other costs include payments to the parties providing corporate, trust, administration and agency services. For securities issued to public there will also be small annual payments to the rating agency, stock exchanges and clearing-houses that facilitate their trading, settlement and custody. Since these costs pertain to the SPV, they are generally recognized in its books.

Capital costs are the costs of providing additional capital support to the SPV in the form of cash-collateralization, over-collateralization or subordinated structure. All sources provide cushion to the SPV by bearing losses before the investors. Any capital the originator injects, increases the cost of funds in securitization.

RATING FACTORS

The purpose of a rating agency is to apprise the investors of the credit risk of the issue in question which involves a thorough evaluation of various factors. While rating a securitization transaction, analysts at JCR-VIS carry out an in-depth analysis of the transaction, underlying assets, cashflows, legal and structural protections and quality of the servicer. Moreover, credit enhancement features provided in the transaction are also carefully reviewed and incorporated in the ratings.

Transaction Structure Analysis

A number of potential risks must be addressed and covered by the transaction structure. These include interest rate risk, prepayment and reinvestment risks and currency risk. For instance, in the FFS transaction of Pakistan Telecommunication Company Limited (PTCL), which was the first Asian telephone company to securitize the future telecom receivables worth US\$ 250m in 1997, the transaction was rated several notches above Pakistan's

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sovereign rating as the structure of the transaction provided protection from Pakistan's sovereign foreign exchange and convertibility risk.

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credit of the originator, the ratings of FFS transactions are invariably linked to the credit quality of the originator. Hence, analysts at JCR-VIS will only consider notching the FFS transaction rating above the originator's entity rating, if the receivables are likely to be generated even after the originating company has defaulted on its senior unsecured debt and a legal structure is in place to ensure the same. This also implies the appointment of a competent backup servicer, which has been discussed at length later in this section.

Asset Analysis

For our analysts at JCR-VIS, it is imperative to gauge the credit quality of assets being securitized and originator's ability to generate and manage assets. This entails conducting due diligence meetings to evaluate the originator's underwriting procedures and discuss the historical performance data of the assets.

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past performance - typically five years of default and delinquency data - and an understanding of how and why this performance may significantly change going forward. Future expected performance would be a function of a number of factors viz. default history and future generic changes affecting the assets. These factors establish the foundation to assess loan seasoning, concentration risk and prepayments. Further, the performance and nature of gener-

al market, the originator's competitors and position in the market as well as the industry specific risks are also analyzed closely.

Cashflow Analysis

This involves analysis of the cashflow model which should reflect the fund flows as depicted in the transaction including the stress assumptions derived in the asset analysis phase. The model should demonstrate that the cash flowing out to pay the investors is always adequate to ensure that they are paid in full on a timely basis. The cashflow must also reflect the priority of payments in the transaction documents.

Legal Issues & Documentation Analysis

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isolate the assets transferred by the originator to the SPV from bankruptcy risks associated with the entities involved. This essentially requires a true sale to be achieved in the transfer of assets from the originator to the SPV so that it has a perfected, first priority ownership in the assets and the originator does not retain any residual beneficial interest in the underlying assets. As a rating agency, true sale to a bankruptcy remote SPV is one of the most crucial aspects to be checked by the analysts at JCR-VIS, since it is a principal risk mitigant available to the investors in the transaction. Hence, JCR-VIS will require the legal counsel to deliver an opinion that all actions necessary to perfect the SPV's

rights in the assets have been taken. This minimizes the risk of re-characterization of sale, by the court of law, as a secured loan rather than a true sale in the event of originator's bankruptcy. Since these opinions are simply views of legal counsel, it is important that a reputable and competent firm having knowledge and experience in such matters of law provides them.

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benefits and risks to the SPV. This entails fulfillment of a number of conditions including a contract of asset assignment specifying the transaction to be construed as sale of assets between the parties concerned, the assigned assets to be specified, the fair value of assigned assets and payments for them to be matched, and the originator having no repurchase obligation and has no recourse to the assigned assets. Further, careful review of the documentation regarding the transaction provided by the issuer's legal counsel is also required.

Notices and acknowledgements also aid in providing legal opinions with regards to true sale. In order to address payment diversion risk, which may result in the obligors directing payment of SPV's receivables to the originator, the originator instructs the obligors of the transferred receivables to make all payments to a collection account under control of a trustee.

The obligors acknowledge the receipt of these notices by countersigning them. In some countries, certain laws provide for perfection of assets sold to SPV; for instance in Japan, under the law regarding Regulation of Business Concerning Specified Claims, public notice of the registration constitutes the validity of perfection.

Besides being unaffected by the originator's bankruptcy, it is imperative that the SPV be remote from its own bankruptcy. This is accomplished by restricting the scope of operations of the SPV in order to secure its independence.

competent back-up servicer who replaces the existing servicer in the event of termination or breach by the servicer of the servicing agreement entered into with the trustee. In case of FFS, the transaction documents will usually provide for the right to appoint an independent back-up servicer if these events occur, but the back-up servicer is not necessarily identified at the time the transaction is concluded.

Further, if the originator is the servicer, its role should be clearly defined as a collection agent providing services to the SPV on an

Measures Securing the Independence of an SPV

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| i. The SPV does not engage in any operations other than securitization. | iv. It does not assign its assets or merge with another company. |
| ii. It does not engage in operations in its own name. | v. It is managed by directors independent of the originator. |
| iii. It does not owe any debts other than those related to securitization. | vi. Existence of consent of parties to securitization not to file for the bankruptcy of the SPV. |

SBP and SECP have also laid down certain criteria to secure the independence of SPV. This includes clauses such as originator restricted from holding any equity stake in the SPV or having any of its directors, officers or employees on the board of SPV and in case where originator is also the administrator, the administration services to be provided on an arms length basis and on market terms and conditions.

Servicer Issues

The structure of an ABS transaction will often involve the appointment or identification of a

arm's length basis and the originator must be paid a reasonable fee for its collection services. It is also vital to establish measures aimed at protecting and preventing the commingling of receivable collections by isolating the SPV's receivable collections from other funds held by originator and directing them to the SPV's trustee.

Credit Enhancements

In order to mitigate the potential loss associated with the credit risk of the assets and the disruption of payments on the securities, securitized transactions have several levels of credit

enhancement both internal and external. Some forms of internal credit enhancement are:

Over-collateralization – This is achieved by the SPV owning assets of a greater value than the funds it raises from the investors. The accounting treatment of this difference will be important for the originator. However, it should be ensured that over-collateralization does not go beyond a certain limit as this undermines the purpose of true sale.

Excess spread account – Such accounts are feasible where the income received on the receivable portfolio is significantly higher than the total running costs of the funds borrowed to finance them. In its simplest form, a spread account traps net excess spread within the SPV to an amount sufficient to satisfy the credit quality requirements.

Cash collateral or reserve account – This is required to safeguard against short-term disruptions in the cashflow. Cash collateralization works in much the same way as over-collateralization except that its quality is self evidently higher and more tangible than the quality of receivables yet to be turned into cash. Cash collateral or reserve accounts maybe drawn at the onset of the transaction and invested with maturity that matches the periodicity of payments to the investors.

Credit tranching – Also known as 'Subordination', in credit tranching structure the cashflows available to the investors are allocated in a predetermined order of

priority. The junior certificate holders will absorb losses before more senior tranches. Further, the senior certificate holders will rank in priority to the more junior notes for coupon and principal payments as well as in the event of the security being enforced.

Performance Guarantee – This entails a range of indemnities provided by the originator to the SPV such as assuring the SPV that the assets were written within regulatory parameters correctly or, in case of consumer receivables, warranting the replacement of the assets which have been incorrectly sold to the SPV and which do not conform to the selection criteria laid down at the outset of the transaction.

Performance deterioration triggers – Also called 'Triggered Amortization', they provide protection to the investors via the early detection of deteriorating credit quality of the receivables in case of ABS and the originator in case of FFS. Such triggers are a regular feature of transactions backed by rapidly revolving assets such as credit cards and personal loans. These performance triggers may result in the trustee trapping additional funds, accelerating amortization of debt and preventing additional asset purchases in case of a revolving structure.

Covenants – In most FFS transactions, there are general corporate covenants that constrain the company's ability to take on additional debt, to pay dividends and maintain debt leverage consistent with the rating assigned.

External credit enhancement may be in the form of a bank letter of credit or a financial guarantee from a financial institution and generally provides assurances of timely payment on securities. The guarantee may either cover part of the issue (Partial Guarantee) or the full amount of the issue (Wrap Guarantee). The institution providing this enhancement must be an

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desired transaction rating. However, according to the ABS guidelines issued by the SBP, banks and DFIs are not allowed to extend any fund or non-fund based facility to the SPV except where the facility is secured against an internationally 'A' rated bank guarantee or against cash or near cash collateral. This limits the role of these institutions in providing credit enhancement to the SPV.

Another mode of external credit enhancement is a put or purchase option, which entails having the originator or a third party agree to purchase from the SPV what is left in the asset portfolio after it drops to a size (normally 10% of the original outstanding amount) which is considered too small to be economically administrable when held by investors.

Securitization has a long way to go in Pakistan although a few transactions have already taken place. As investors become savvier and more receptive towards innovative forms of funding instru-

ments, the growth in securitization market is expected to pick its pace. The SBP has also issued its guidelines to facilitate banks/DFIs and other parties performing various roles in securitization.

However, there is need for these regulations to be a little more flexible to allow room for enhancing the scope and support mechanisms for securitization so that its true benefits can be tapped.

JCR-VIS

**Faheem Ahmad**

President & CEO, JCR-VIS
Founder, VIS Group

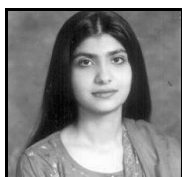
Faheem Ahmad has diverse experience with international consulting agencies in USA & Middle East. He has also held senior positions with local industrial and financial groups. In 1994, he established Vital Information Services (Pvt.) Limited, which is a leading capital market research house. VIS has the largest data bank of corporate Pakistan. His major research work includes copyrighted F&J financial strength rankings, Musharaka Variable Income Securities and stock market indices. VIS group includes JCR-VIS Credit Rating Company Limited and News-VIS Credit Information Services (Pvt.) Limited, the first private credit bureau of Pakistan. The majority of shareholders in group companies include the largest publication house in Pakistan and major financial institutions.

He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters degrees in Engineering and Business Administration from USA. His research work has been published in various international journals.

**Kiran Lakhwani**

Assistant Vice President

Kiran Lakhwani, CFA, currently leads ratings of industrial concerns and structured finance transactions. She is also involved in ratings of financial institutions. She holds a Masters degree in Business Administration from the Institute of Business Administration, Karachi.

**Mehvish Salim Virani**

Analyst

Mehvish Salim Virani is actively involved in ratings of structured finance transactions and industrial concerns. She holds a Masters degree in Business Administration from the Institute of Business Administration, Karachi.

Jahangir Kothari Parade (Lady Lloyd Pier)

Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose generosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.



Jahangir Kothari
Parade

National Excellence, International Reach

JCR-VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, JCR-VIS is positioned to aim for an international mark. In this regard, the global experience of our principal, Japan Credit Rating Agency, Ltd. has been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors.

The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, JCR-VIS continues its endeavor to remain an emblem of trust.

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Founder Shareholder of Islamic International Rating Agency, Bahrain
JV Partner in CRISL, Bangladesh
Member Association of Credit Rating Agencies in Asia

First Floor, PIDC House
M.T. Khan Road, Karachi - Pakistan
Tel: (92-21) 5680766, 5680996, 5671822, 5671833
Fax: (92-21) 5681105, 5671600
E-mail: vispk@cyber.net.pk
Website: www.jcrvis.com.pk