The global alchemy of asset securitization.

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In recent years, asset securitization has become one of the most important financing vehicles in the US. Its use, however, is now rapidly expanding world-wide. Examples include the securitization of telephone and oil revenues in Mexico, of mortgages in the UK, of credit cards and consumer loans in France, and of leases in Japan.

This article will explain asset securitization and its unique benefits. In particular, the article will explain why securitization enables many companies to raise funds at a lower cost than through traditional financing.

How securitization works
A company that wants to obtain financing through securitization begins by identifying assets that can be used to raise funds. These assets typically represent rights to payments at future dates and are usually referred to as receivables. The company that owns the receivables is usually called the originator.

After identifying the assets to be used in the securitization, the originator transfers the receivables to a newly-formed special purpose corporation, trust, or other legally separate entity—often referred to as a special purpose vehicle, or SPV. The transfer is intended to separate the receivables from risks associated with the originator. For this reason, the originator will often structure the transfer so that it constitutes a true sale; that is, a sale that is sufficient under bankruptcy or similar law to remove the receivables from the originator's bankruptcy estate.

To raise funds to purchase these receivables, the SPV issues securities in the capital markets. The SPV, however, must be structured as bankruptcy remote to gain acceptance as an issuer of capital market securities. Bankruptcy remote in this context means that the SPV is unlikely to be adversely affected by a bankruptcy of the originator.

To achieve bankruptcy remoteness, the SPV's organizational structure strictly limits its permitted business activities. The goal is to prevent creditors (other than holders of the SPV's securities) from having claims against the SPV that might force the SPV into bankruptcy or insolvency. Furthermore, an SPV that is owned or controlled by the originator may be required to have one or more independent directors. The SPV must also attempt to observe all appropriate third party formalities with the originator. These additional steps help to reduce the risk that the originator, if bankrupt, will either cause the SPV to file for bankruptcy or persuade a court to use equitable powers to consolidate the assets and liabilities of the SPV with those of the originator.

How companies benefit from securitization
Through the securitization process described above, the SPV raises funds by issuing securities and uses the receivables purchased from the originator to repay investors in the future. The investors, therefore, are concerned only with the cash flows coming due on these receivables, and care little about the originator's financial condition.

Securitization is most valuable when the cost of funds, reflected in the interest rate that is necessary to entice investors to purchase the SPV's securities, is less than the cost of the originator's other, direct sources of funding. The SPV's lower cost of funds is passed on to the originator through a higher selling price for the originator's receivables. The goal of securitization, therefore, is to obtain low-cost capital market funding by separating all or a portion of an originator's receivables from the risks associated with the originator.

The interest rate necessary to entice investors to purchase the SPV's securities is often a function of the rating that the SPV's debt securities receive. These ratings are determined by a handful of independent rating agencies, such as Standard & Poor's and Moody's. Given that most investors have neither the time nor the
resources to fully investigate the financial condition of the companies in which they invest, these ratings take on special significance. Investors often rely on the assigned ratings to determine the minimum return that they will accept on a given investment.

Companies whose debt securities are rated investment grade can usually issue securities in the capital markets at interest rates competitive with, or even lower than, other generally available sources of funds, such as bank loans. The higher the company's rating within the investment grade categories, the lower the company's cost of funds. This reduced cost is a result of the lower interest rate necessary to induce investors to buy the company's securities.

A securitization transaction can provide obvious cost savings by permitting an originator whose debt securities are rated less than investment grade or whose securities are unrated to obtain funding through an SPV whose debt securities have an investment grade rating. Even an originator with an investment grade rating may derive benefit from securitization if the SPV can issue debt securities with a higher investment grade rating and, as a result, significantly decrease the originator's interest costs.

One might expect securitization to be of greatest benefit to riskier companies. This, however, is only partly the case. As a company moves toward the extremes of financial instability and the brink of bankruptcy, securitization is less of a benefit. At this point, the SPV structure has a higher than normal risk of being challenged, and risk-averse investors tend to avoid these transactions.

Asset securitization does, however, afford companies with acceptable risk levels the possibility of real cost savings. To determine whether an originator will achieve an overall cost savings from securitization, one must assess the interest savings possible against the costs of the securitization transaction. A company considering securitization should compare the expected differential between interest payable on non-securitized financing and interest payable on securities issued by an applicable SPV with the expected difference in transaction costs between the alternative funding options.

If, however, the securitization transaction is off balance sheet, a strict debt-to-debt comparison may understate securitization's benefits. Off-balance sheet securitization has its own inherent advantages because it does not put pressure on the originator to raise additional equity capital. Furthermore, whether or not the originator will achieve a cost saving partly depends on the way in which the originator structures the securitization, because, as will be shown below, transaction costs can vary widely.

One-off securitization structures
In most securitization transactions, the SPV is created specifically for the particular originator and the particular transaction. The objective of this so-called one-off securitization is to provide the originator with significant flexibility to customize the securitization in terms of its particular structure and the types of capital market securities issued. However, because one-off structures are created for a particular transaction, their transaction costs can be high; they can rarely achieve the transaction cost economies of scale realized by multiseller securitization conduits.

In addition, to avoid subjecting the originator to the liabilities of a thinly-capitalized SPV, tax and accounting rules may require a minimum level of capital, such as 1% to 3% of the amount of the securities issued. In contrast, a multiseller securitization conduit should need only nominal capital because the multiplicity of sellers reduces the risk that the SPV will be regarded as the alter ego of any one seller. Given these differences, only a case-by-case comparison of costs and other motivations will determine whether a one-off or multiseller structure is more advantageous to a particular originator.

Originators desiring medium- or long-term financing can often access the capital markets through securitized private placement transactions. In these transactions, an SPV is created for a specific deal and issues medium-term or long-term notes. A private placement takes advantage of the one-off structure because the private placement's requirements are determined primarily by the investors, who actively participate in analyzing the receivables and negotiating the structure of the deal with the originator. In addition, the investors' sophistication allows for a great deal of creativity in both the structure and type of receivables used. The SPV's securities only need to be rated if the investors so require. The interest rate on such securities may, however, be higher than normal because privately placed securities often cannot be freely traded.
Investment grade originators that have highly predictable receivables, or that obtain investment grade credit enhancement, may be able to offer long-term securities publicly through an SPV to investors in the capital markets. Because of the demand for publicly-traded securities, this type of transaction would provide long-term financing with the lowest interest rate cost to the originator.

The transaction costs of a public offering, however, are high. Not only must an SPV be created specifically for the financing, but it also must prepare and file a registration statement with the SEC or other applicable regulatory agency. In contrast to a private placement transaction, which can often be accomplished in a period of weeks, a public transaction can take months to accomplish. In addition, the level of due diligence required to satisfy governmental disclosure requirements can be daunting. For this reason, public securitization is rarely cost-effective for smaller transactions.

The repayment of securities issued in one-off securitization structures is often guaranteed in whole or in part by creditworthy third parties in the business of assessing this kind of risk, such as banks or surety companies. The providers of these guarantees, often referred to as credit enhancement facilities, make independent decisions on whether to extend such enhancement and how much to charge for it. Although obtaining credit enhancement adds to transaction costs, the net effect may reduce total costs because securities supported by credit enhancement obtain higher credit ratings. As a result, the interest rate payable on such securities will be lower.

**Multiseller securitization conduits**

A multiseller securitization conduit offers originators the opportunity to minimize their transaction costs by utilizing a common SPV. These conduits are typically administered by commercial or investment banks and are able to achieve a transaction cost economy of scale by allowing multiple originators to sell receivables to a single pre-existing SPV.

To date, most multiseller securitization conduits have accommodated only investment grade originators. This selectivity minimizes the risk — already rendered unlikely because of the bankruptcy remote structure — that a single originator’s bankruptcy might adversely affect a conduit engaged in transactions with many originators. However, a limited number of multiseller securitization conduits have recently begun to serve originators whose debt securities are rated less than investment grade. As a result, more originators are now able to take advantage of the transaction cost economy of scale.

Multiseller securitization conduits, like one-off structures, may benefit from credit enhancement. However, multiseller conduits usually issue short-term securities, such as commercial paper. Rating agencies will determine the ratings of such short-term securities based not only on the ultimate risk of default but also on the probability of timeliness of payment. As a result, rating agencies often insist that creditworthy third parties ensure timely payment. Liquidity facilities help to assure that the multiseller conduit will have the liquidity available to meet short-term financial obligations in the event that cash flow from collections is temporarily insufficient. Providers of liquidity facilities are then repaid by collections on receivables when received. In most instances, the conduit will be able to pay maturing short-term debt securities through its collections on purchased receivables or by re-issuing commercial paper. Only when these sources are not sufficient to meet the conduit’s short-term financial obligations will liquidity facilities need to be funded to assure the conduit of the necessary cash flow.

The result is that multiseller securitization conduits typically utilize both liquidity facilities and credit enhancement. Providers of liquidity facilities often insist that conduits obtain credit enhancement as well to emphasize that the liquidity facilities are ensuring only timeliness of payment and not guaranteeing against ultimate loss. They also may require credit enhancement if they are uncomfortable with the structure or the level of security of a given transaction.

Because liquidity facilities and credit enhancement significantly reduce risk on securities issued by a multiseller conduit, rating agencies base their evaluations of such securities primarily on the liquidity and credit enhancement facilities that the conduit obtains. Obtaining these facilities will, however, add to transaction costs, and their value in reducing interest costs must be adjusted accordingly.

**Indirect costs and benefits**

The preceding sections discussed how variations in securitization structures can affect direct transaction costs and flexibility. Each structure is also associated with certain indirect costs and benefits. For example, transaction costs are not necessarily limited to direct expenses, such as fees for lawyers, investment bankers, and liquidity or credit enhancement facilities. They may also arise from the true sale requirement.

To achieve a true sale, an originator must sometimes limit, if not forgo, its right to the residual value of the receivables sold to the SPV. This residual value can be significant since the SPV must obtain a level of receivables well in excess of the amount necessary to pay the securities issued by the SPV. Such over-collateralization is needed to assure investors and providers of liquidity and credit enhancement that they will not suffer losses from delayed collection or defaults. Conflict may develop over the amount of over-collateralization necessary for the SPV: originators want the level of over-collateralization to be low, while investors and credit enhancers want it to be high. Because the amount of receivables sold may turn out to be greater than what was needed to pay the SPV’s securities, the overpayment would represent an indirect, but real, cost to the originator.

The cost of over-collateralization can be managed in several ways. If the originator’s rating is investment
The indirect benefits of securitization will often more than compensate for its indirect costs. One of the most important indirect benefits is that asset securitization provides a source of off-balance sheet funding. Because a securitization is usually viewed, for accounting purposes, as a sale of assets and not as financing, the originator does not record the transaction as a liability on its balance sheet. Such off-balance sheet funding thus raises capital without increasing the originator's leverage or debt-to-equity ratio on its financial statements.

Another benefit of asset securitization is that it may represent an additional and untapped source of financing for an originator. Sometimes originators will find that investor appetite for their securities has become temporarily sated. In other words, the amount of originator risk exposure that the capital markets are prepared to accept may be less than the amount of capital market financing desired by the originator. In these cases, securitization permits the originator to obtain additional capital market funding through an SPV.

Certain securitizations may also result in a lower-weighted average interest rate to the originator through the use of a senior/subordinate securities structure at the SPV level. Sophisticated investors provide the equivalent of credit enhancement to the SPV by purchasing subordinated securities. The originator thereby allocates certain repayment risks to these investors, who are in the business of assessing and accepting such risks and who consequently are willing to accept a higher level of risk than the average investor. The interest rate on these subordinated securities would be higher than the interest rate on the non-subordinated (or senior) securities to compensate for the greater risk. Nonetheless, this combination of senior and subordinated securities will still be of benefit to the originator if, as is usually the case, the resulting blended interest rate on the combined securities is lower than the rate that would have been applicable if only one class of securities had been issued.

The senior/subordinate structure can also be used to expand the universe of parties available to provide credit enhancement. An entity providing external credit enhancement in the form of a guarantee or its equivalent is usually required to have a credit rating at least equal to that of the securities being guaranteed. However, the number of highly-rated credit enhancers — including banks — is relatively small.

**Securitization distinguished from factoring**

Traditionally used throughout the world, factoring, like securitization, entails a sale of receivables to generate cash. Given the superficial similarities between the two financing techniques, it is useful to compare them and consider when each applies.

In a factoring transaction the factor is typically a pre-existing finance company which realizes its profits by buying receivables from clients at a discount. Securitization, in contrast, usually involves the creation of a bankruptcy-remote SPV which purchases receivables from the originator and issues asset-backed securities into the capital markets. Whereas factors rely on their specialized knowledge of collection to reduce their risk of loss, the SPV minimizes its risk through the purchase of quality receivables with predictable rates of default. The differences between securitization and factoring, however, are not rigid and begin to blur in certain instances. For example, there are fewer differences between securitization and factoring in transactions where an SPV borrows funds from non-capital market sources instead of issuing securities, or where a factor funds itself through the issuance of capital market securities.

In certain circumstances, the principles used in securitization and factoring may be combined to obtain even lower cost funding than through either conventional securitization or traditional factoring. For example, small and medium-size companies may be able to benefit from structures, such as the divisible interest structure, that provide capital market funding without the extra cost of creating an intermediary SPV.

In the divisible interest structure, an originator would sell, for a negotiated fixed price, its rights in a pool of receivables equal to 100% of all collections up to a trigger point. Once fixed, there is no adjustment to the purchase price, irrespective of actual collections, and because the transfer is directly from the originator of the receivables to the issuer of the securities, there is no need to create an intermediary SPV, as in the two-tier structure.

Thus, the divisible interest structure permits multiple originators to pool their receivables in a single securitization and thereby achieve economies of scale. It also reduces the transaction costs of a two-tier structure. Therefore, the combination of concepts from securitization and factoring can lead to innovative and synergistic structures and approaches.

**Does securitization reduce net financing costs?**

A zero-sum game is one in which one person’s benefit exactly offsets another person’s loss, so that the net payoff of the entire game is zero. Is securitization a zero-sum game, or does it create a genuine cost reduction for parties?

We have seen that, despite its transaction costs, securitization can be less expensive than other funding sources because it enables originators to obtain low-cost capital market funding. Even investment grade originators who already have direct access to capital market funding may prefer securitization because of its indirect benefits, such as the provision of off-balance sheet funding. Although indirect benefits are harder to quantify, many companies that use securitization are
This fact is significant when one considers that profit-maximizing companies generally do not engage in activities whose benefits are illusory.

These observations leave unanswered, however, the question of whether securitization enables originators to realize a gain at the expense of others, such as the originator's unsecured creditors. For example, some critics have argued that unsecured creditors are harmed by securitization because it reduces the amount of the originator's unencumbered assets available for debt repayment. This argument is flawed, however; securitization merely replaces one type of asset, receivables, with another type, cash. The unsecured creditor has the same amount of unencumbered assets to levy against after the securitization as it did before the securitization.

Other critics have argued that cash raised in securitization is unlikely to stay within the originator. However, one cannot assume wasteful behavior simply because an originator sells its receivables for cash. In fact, given the scrutiny imposed by rating agencies and other independent parties such as credit enhancers, securitization may present fewer opportunities for self-dealing than other financing methods. Nonetheless, securitization, just like any other sale of assets by an originator, may become suspect if implemented when an originator is on the brink of bankruptcy. An originator, for example, may be seeking to convert receivables into cash to make preferential payments to certain creditors or even to fraudulently hide assets.

The potential for such actions, however, is not unique to securitization transactions. The same issues would arise, for example, if on the eve of bankruptcy an originator sold, or borrowed money by encumbering, a factory or equipment and similarly sought to dissipate the sale or loan proceeds. Such questionable uses of proceeds are more appropriately addressed by preference and fraudulent conveyance laws, or other laws which seek to ensure equality of distribution of a debtor's estate.

The question nonetheless remains: does securitization genuinely reduce net financing costs? A securitization provides a new source of financing—the capital markets, whose rates are systematically lower than the rates at which non-investment grade firms commonly borrow. Prior to engaging in a securitization, an originator may be financing itself through secured and unsecured loans. After the securitization, the originator raises funds by accessing the capital markets through the SPV.

The transformation from loan financing to capital market funding with its comparatively lower interest rate thus can reduce net financing costs. So long as the added transaction costs are less than the interest saved by using securitization instead of loan financing, securitization can create a net gain.

But why should the capital markets be prepared to fund securitization transactions at a lower rate than secured financing? One explanation is that securitization serves as a means of reducing monitoring costs. Because the interest rate on a loan is determined when the loan is made, a borrower may take actions that increase the loan's riskiness after the loan is made. A creditor will incur certain monitoring costs as a result to ensure that the borrower's actions do not increase the riskiness of the loan. Even secured financing may not reduce the need to monitor the borrower's financial condition. If the secured creditor's ability to exercise remedies against the collateral could be impaired by a bankruptcy, a secured creditor will have a significant interest in ensuring the continued viability of the borrower and will incur monitoring costs to further that interest in addition to the costs of monitoring the collateral.

In a securitization, on the other hand, the originator's receivables are sold to a bankruptcy remote SPV in a true sale. Consequently, a bankruptcy of the originator would not adversely affect the ability of investors to receive payment on their asset-backed securities. Because a bankruptcy-remote structure separates the source of payment of the SPV's securities from the risks associated with the originator, the need to monitor the originator's financial condition is largely eliminated.

Although the risks associated with servicing and collecting the receivables still necessitate some monitoring, these risks can be borne by providers of credit enhancement or investors in subordinated securities, parties who are in the business of precisely assessing and absorbing such risks. By causing the SPV to issue a combination of senior securities to ordinary capital market investors and subordinated securities to sophisticated investors, an originator can minimize the effect of asymmetric information among investors and thereby obtain a lower blended interest rate and therefore lower credit costs. Credit enhancement minimizes the effect of asymmetric information among investors through the use of highly rated institutions that wish to profit by guaranteeing all or a portion of the securities issued to investors.

Conclusion

In many cases, securitization not only reduces an originator's direct financing costs but also provides significant indirect benefits. Securitization entails real costs, however, and therefore should only be used after comparison with alternative sources of funding. In the international arena, there may be additional issues, such as dealing with foreign currency exchange, tax, and sovereignty considerations, as well as legal systems that may not always be focused on asset-based financing. Nonetheless, securitization has only been applied to a portion of its potential market opportunities. It therefore promises to be a financing technique that will continue to grow. Securitization, in short, brings to financial technology what the sought-after philosopher's stone promised to bring to base metals— the ability to turn them into gold.

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