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PARTICIPATION BY SOUTH AFRICAN BANKS IN SECURITIZATION

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Securitization discloses signs of development in South Africa. Legislation governing securitization has been in existence since 1992. However, developments have been slow for a variety of reasons. One such reason pertain to the reluctance of South African Banks in participating in and/or originating securitization transactions combined with the past perception, that the use of securitization is limited to banks; and banks not having a need to use securitization given its capital adequacy and historic lending margins.

Securitization offers different levels that promote bank participation in securitization which participation may fuel bridging liquidity concerns of investors, coupled with fee-income maximization opportunities for banks.

This article looks at the levels of participation, within securitization, by banks, referring to legislative and accounting impact on the participating bank as well as perceived investment risk. Legislative aspects include, the Banks Act 94 of 90 (Banks Act), the Securitisation Schedule, Notice 153 (Sec.schedule) and the Commercial Paper Schedule, Notice 2172 (CP schedule). Accounting aspects deal with Accounting Standard (AC) 120 - *Disclosure in financial statements of banks*. All from an off-balance sheet point of view.

The levels, apart from originating, consist of servicer and/or backup servicer, underwriter of asset-backed security programs, investor, interim funding facilitator, and credit enhancer.

Originator

A bank securitizes a portion of its interest-bearing assets. The proceeds are used to enhance lending growth allowing for the opportunity to widening the bank's lending margins. Should the bank retain the servicing, the meaning of off-balance sheet activities measured against the Sec.schedule and capital requirements as per the Banks Act need to be considered. Where mortgages are being securitized, the risk exists that the risk weighting may increase from 50% to 100%. Where other interest bearing loans, with a risk weighting of 100% are being securitized, the risk weighting remains. Off-balance sheet activities include the meaning assigned to "managing portfolios on behalf of a third party", "managing portfolios where financing is provided" and "managing portfolios where the replacing of credit is evident". All three meanings are evident in a bank- originated securitization.

The key in solving off-balance sheet disclosure and increased capital requirement risk hinges on proof beyond doubt that the originating bank retains no credit risk.

Equity investors could be of the opinion that quality interest-bearing loans are being securitized thereby potentially increasing bad debt risk, hence reducing profitability. Should the bank have adequate risk measurement and provisioning policies in place, such risk is non-existent, especially where the proceeds from the securitization are re-invested in interest bearing loans with an interest rate higher than the rate attached to the interest-bearing loans being securitized. The equity investor stand to gain through the "value-unlocking" brought about through securitization.

Debt paper investors gain through a well structured and rated securitization transaction in the form of a higher yielding investment alternative. The equity-investment risk, referred to in the preceding paragraph, may be leveraged in an instance where the equity investor and the debt paper investor are the same.

Servicer

In servicing or back-up servicing capacity, the bank facilitates collection relating to a securitization being originated by a third party not related to the bank. The Sec.schedule will not apply, safe to the extend that AC 120 does not apply or become applicable where system risk may create commingle- and credit risk. Servicing caters for enhanced profitability through the fee income that the bank earns, having a positive contribution on equity investment returns.

Debt paper investors gain from added comfort knowing that a bank's collection system forms part of the SPV administration activities.

Underwriter

As an underwriter, the bank participates in the placing and issuing process of asset-backed securities being issued by an SPV. Underwriting attracts a 50% risk

weighting, allowing the bank to earn fee income translating into higher return on capital. Securitization underwriting activities should however be measured against the meaning of off-balance sheet activities within AC 120 and the Banks Act. The Sec.schedule will not apply, given that the securitization is not being originated by the bank [Sec.schedule does not permit the underwriting and origination to be performed by the same bank]. The portion of debt paper not being placed are taken up by the bank which then, given the quality of the structure and rating aspects to the transaction, will require additional credit spread in order for the bank to make trading profits in the secondary market. Until such time as the remaining portion of debt paper is traded in the secondary market, the bank's credit exposure will require, that such portion be treated as an investment, which will attract a 100% risk weighting, hence the required additional credit spread for the risk attached to an increase in capital requirements. Additional derivative profits may be realized, through the application of existing hedging and derivative acumen combined with sophisticated trading systems measured against the efficiencies by which existing trading and hedging activities are being conducted.

Endorsing of debt paper, having certain benefits for the SPV, as promulgated within the CP schedule, represents a higher risk of underwriting to the extend that the bank is exposed to the credit risk of the entire issue. This should be measured against the meaning of off-balance sheet activities within AC 120 and the Banks Act, requiring a 100% risk weighting. The Sec.schedule will not apply.

Equity investment returns are improved through fee income that the bank is earning against its underwriting exposure as well as trading profits as a result from secondary market trading and hedging activities associated with underwriting activities. Investment risk attached to investment in debt paper is reduced, which caters for the possibility of a lower credit spread, but to the advantage of the underwriting bank and not necessarily the SPV.

Facilitator and structurer

This level allows a bank to participate in all levels of a securitization. Where the bank owns and control the SPV, the bank, in terms of the CP schedule will be the ultimate borrower. The Sec.schedule will not apply. However, all aspects that fall within the meaning of off-balance sheet activities within AC 120 and the Banks Act will apply. The bank will have to consolidate the SPV on its balance sheet.

Under this arrangement, a bank will not be allowed, in terms of the Sec.schedule, to facilitate the origination of its own securitization. Given an acumen requirement of securitization, to have investment and lending decision making combined, compared to the lending driven credit vetting of South African banks, this level of participation may potentially create more problems than opportunities.

International accounting developments, regarding accounting for consolidations, could leave the bank in an increased capital requirement risk situation.

Equity investment returns could be lower than returns generated by traditional and conventional lending activities. Debt paper investors will experience nothing different to a situation where the bank issues its own corporate bonds in increasing its tier-2 capital base. Hence, asset-backed securities resemble a corporate bond issue [Recent study conducted by Standard & Poor's suggest higher stability within the ratings of asset-backed securities compared to corporate bonds and government/municipality debt[1]]

Investor

The bank invests in a portion of, or in the whole of asset-backed securities being issued by an SPV, as apposed to investing capital in interest bearing loans. It offers the bank the opportunity to earn returns in excess of returns it would have earned on a comparable loan basis, for instance, investing in securitized mortgages. It offers the bank the flexibility to trade in and out of interest bearing securities, which under a loan arrangement would have been illiquid.

AC 120 as well as the Sec.schedule will not apply since the investment is on-balance sheet. The Banks Act will require that a risk weighting of 100% be maintained against the investment in asset-backed securities irrespective of the assets or cashflow forming the basis of the securitization. Given the bank's system and hedging capabilities it may earn fee income from facilitating an SPV's hedging requirements.

Equity investment returns are improved, since the bank is fueling profitability through offering an added product/service. Debt paper investors gain through improved comfort, which support secondary market liquidity to the asset-backed security issue.

Interim funding facilitator

Providing interim funding to the structuring process of the securitization, allows the bank to earn interest income that is not different to normal lending activities. Interim funding is conducted internationally. This level of participation support improved structuring turn-around time, also offering an SPV the opportunity to commence earlier with the marketing and placing of debt paper through an offering circular, effectively locking in interest rates before completion and launching of the securitization. AC 120 and the

[1] Standard & Poors's US Asset-Backed Securities Review by Dr. Joseph Hu, January 2000

Sec.schedule will not apply. Capital requirements will apply according to the Banks Act.

Equity investment returns are improved through product/service diversification over shorter time horizons, as apposed to an illiquid on-balance sheet lending asset, whilst debt paper investment risk is reduced.

Interest rate risk attached to the investment in asset-backed securities are being reduced for debt paper investors as a result of hedging efficiencies within the bank, that can be extended to include the hedging of pre-listing and pre-issuing interest rate risk.

Credit enhancement

Given the nature of credit vetting, bank participation within this level of securitization brings with it benefits to all participants within a securitization, since external credit enhancement is a credit related decision. External credit enhancement may take on a variety of forms, of which the most commonly used internationally includes, surety bonds, guarantee, letter of credit and liquidity facilities. A liquidity facility is a common feature within multi-seller securitization programs and cross-border future- flow securitization transactions.

Adding the sophistication of rating in explicitly identifying the level of risk quantification, the bank has the opportunity to earn fee income against properly calculated risk. The Sec.schedule will not apply on the bank. However, AC 120 and the Banks Act will apply with regard to risk weightings pertaining to whether the enhancement is performance or financial related. The Sec.schedule explicitly prohibits the use, by an SPV, of funding arrangements other than the debt program for facilitating the securitization. This contributes to liquidity aspects regarding secondary market tradability of an asset-backed security issue.

Equity investment returns are improved, given product diversification within both on and off-balance sheet activities.

Debt paper investors have improved comfort in that a portion of the credit risk is absorbed by an efficient and effective banking system, given the international recognition of the South African Banking System. Secondary market liquidity is improved through the introduction of liquidity facilities available to SPV's, since it addresses unforeseen temporary adverse pool performance. This is one area where, given the existing securitization legislative framework, that supports transparency, coupled with a solid and good banking regulatory environment, securitization legislation could be expanded to further fuelling securitization developments.

Summary

South Africa has a good regulatory system governing an efficient banking system and industry. The legislative framework that governs securitization, coupled with the effectiveness of mechanics by which South African Exchanges operate, especially The Bond Exchange of South Africa, caters for an opportunity whereby banks can participate in securitization in adding value to the development of securitization in South Africa.

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