

Guide to

# STRUCTURED FINANCE

Incorporating  
Securitisation, Credit Derivatives,  
Leasing & Real Estate Investment Trusts

**Vinod Kothari**

Second Edition  
2023

*Guide to*  
**Structured  
Finance**

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*Incorporating Securitisation, Credit  
Derivatives, Leasing, and Real Estate  
Investment Trusts*

Second Edition

**2023**

by

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Assisted by

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## Preface of second edition

The importance of structured finance continues to grow, as financial institutions create and market solutions to specific financial needs, often linking with cashflows or specific assets of the borrower. Not only are various components of financial facilities sliced and diced, but even the functions of sourcing, origination, credit underwriting, risk absorption, servicing and recovery are shared across a spectrum of different entities. The advent of Fintech is bringing fundamental changes in the way financial products are originated and serviced.

In this environment, structured financial solutions are the order of the day.

This book contains a treatise on 4 diverse topics, having a level of inter-connectivity: securitisation, credit derivatives, asset-backed financing and leasing, and real estate investment trusts. Each of these instruments involve, in some sense, use of structuring principles.

The first edition was published some 8 years ago, and in the meantime, there have been considerable developments in each of these subjects. The book has comprehensively been revised and updated.

The approach in this edition has been that while market developments have discussed and brought upto date wherever possible, however, we have not gone for temporal market data. Books have longer shelf lives and it is not expected that readers will be depending on such a book for latest market data. Hence, developments that have a lasting impact and may be seen as trends have been discussed.

Further, this book has a global character and discusses global developments at length. However, there is sufficient attention given to the market, law and regulations as applicable to India. Thus, global readers as well as Indian readers will find the book useful.

My colleague Abhirup Ghosh has taken up the arduous task of editing and updating this edition. He has been ably assisted by Subhojit Shome. I am indeed thankful to them.

I am hoping readers will find this edition useful.

Kolkata

2<sup>nd</sup> November 2022

Vinod Kothari

# Preface of first edition

This book deals with a package of 4 subjects – securitisation, credit derivatives, operating lease, and real estate investment trusts, all bundled together under the title – structured finance. All the 4 financial instruments involve elements of structuring a financial product, and therefore, have elements of commonality.

Securitisation and structured finance are quite often used as interchangeable expressions, though, properly speaking, securitisation is a product that uses structured finance principles. Securitisation was into the thick of controversy in the aftermath of the 2007-8 financial crisis, and regulators world-over were busy examining what was wrong with the securitisation markets that made the financial world go into a tizzy. Obvious enough, the problem lay in the overheated state of the market, and the tremendous extent of leverage prevalent at the given point of time, rather than in the economic argument underlying structured finance. The default rates in home loans shooting up to unanticipated levels in 2007-8 period was the risk of an “unknown unknown”, and no one, including the rating agencies, had factored such a risk. Obvious enough, several of the AAA-rated securitisation tranches fell by the wayside, causing a complete withdrawal of confidence in the market.

While market sentiment is still not restored even as yet, regulators are trying to see what can be done to revive the market. The BCBS-IOSCO Task Force<sup>1</sup> is an example of regulatory efforts to get into the problems currently holding back the revival of securitisation markets.

The growth of credit derivatives has been strongly correlated to that of securitisation. The use of credit derivatives into securitisation led to the creation of synthetic CDOs, and later, index trading, which was clearly the hottest of the products in the structured finance space just before the markets broke down. Lot of people say that the sort of bespoke CDOs being creating and being lapped up by the market around that time had given enough indications that the markets were going overboard. Credit derivatives activity has not picked up as yet – BIS data till end-December 2013 shows a consistent decline both in single-name products as well as portfolio and index transactions<sup>2</sup>.

The use of operating leasing as a structured product is not new – lease transactions have been around over several decades now. As in case of several financial

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<sup>1</sup> <http://www.iosco.org/news/pdf/IOSCONEWS337.pdf>

<sup>2</sup> <http://www.bis.org/statistics/dt1920a.pdf>

instruments, leasing is a product of accounting standards. As the scope for off-balance sheet instruments has generally been narrowed down by standard-setters, operating leases as a time-tested off-balance-sheet instrument has recently gained attention. This is even as global standard-setters are reviewing lease accounting standards to eliminate the present distinction between financial and operating leases, and treat all leases like, with a right-to-use asset and obligation-to-pay liability. Yet, operating leases are not merely all about accounting cosmetics – the age of technology has created enormous possibilities of shared use of a variety of assets, and hence, asset or capacity sharing contracts are going to increase tremendously in time to come. So also, residual-value based contracts will continue to attract more interest.

The book also discusses real estate investment trusts as a device of funding commercial properties. While REITs started as a tax transparency vehicle in the USA in 1960s, lots of countries have recently enabled REITs to act as a tax transparent collective investment device to provide ownership capital to income-earning commercial real estate. REITs combine very well with commercial mortgage-backed securities – a product discussed in the first part of the book.

The package of 4 products discussed at one place provides the reader with ability to gain insights into some of the hottest financial instruments of our time.

The emergence of this book within a very short span of time has been possible only due to enormous energy and dedication of my colleagues, in particular, Nidhi Bothra and Abhirup Ghosh. I am indebted to both of them.

As always, readers' feedback is an author's delight. Hence, I will be obliged if readers were to write a mail giving their constructive feedback.

Kolkata

29<sup>th</sup> September 2014  
Vinod Kothari

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