

Spotlight on the South African environment of securitisation and asset-backed securities

1. INTRODUCTION

Internationally securitisation and asset-backed securities have found wide application within the lending and investment environment. Securitisation originated in the United States of America, the first application being the repackaging of mortgage cash flows into mortgage-backed securities. It is believed that the outstanding asset-backed securities as a result of mortgage securitisation in that country amounts to \$691bn (Fanie Mae, 1997). Securitisation and asset-backed securities have grown substantially in the United States of America and their use has also spread to credit cards, medical receivables, auto loans, commercial loans and royalties. This type of securitisation represents roughly \$150bn of outstanding asset-backed securities.

A similar tendency is also evident in Europe, with the deployment of securitisation and asset-backed securities effectively taking off during 1996 when \$35,4 billion of outstanding asset-backed securities were issued (Choudhury, 1996).

One can ask the question, Why securitise? The benefits associated with securitisation are that it reduces funding costs, it replaces traditional interest income with fee income, it generates fresh cash for new and altering investment and lending strategies, creates opportunity for innovative financial structuring as well as investment alternatives and can be utilised in altering maturity profiles in optimising risk management.

2. THE MECHANICS OF SECURITISATION AND ASSET-BACKED SECURITIES

Securitisation is the pooling of assets with the same characteristics in terms of yield, maturity and geographical spread, which are then sold as a package to a special purpose vehicle (SPV). This implies the re-packaging of individually illiquid assets or cash flows, allowing for third party financing on the basis of these cash flow strengths (Dobson, 1992).

Asset-backed securities are securities that are primarily serviced by the cash flows from a discrete pool of receivables constituted by financial assets either fixed or revolving, either long term or short term, that by their own terms convert into cash within definite time periods, together with any rights or other assets designed to assure the servicing of proceeds to security holders (Morrison, 1993).

In order for investors to invest in asset-backed securities, the quality of the underlying assets needs to be improved. This is done through credit enhancement that forms an important part of the rating process. The degree of quality enhancement depends on investors' appetite for risk and their yield demands, past delinquencies, market and economic conditions.

The structure and mechanics of securitisation and asset-backed securities can be graphically explained as follows:

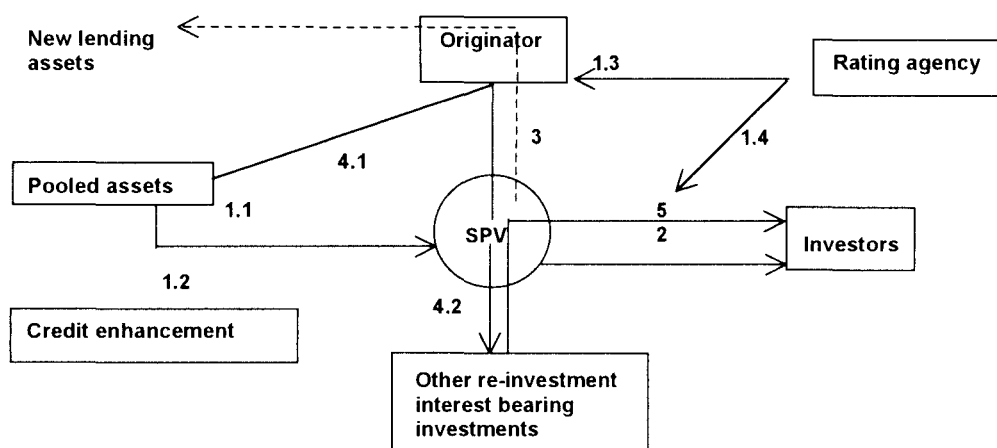


Figure 1: The mechanics of securitisation and asset-backed securities

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1. The pooled loan assets, with the same characteristics (same maturity, industry, interest rate, class of specification), are identified, analysed, packaged and transferred to the special purpose vehicle through securitisation. [1.1] During the analysis of the pooled loan assets the potential credit risk with respect to past default is determined and a third party to the securitisation and asset-backed security issue, enhances the credit quality to align the risk profile of the pooled loan assets with the risk profile of investors [1.2]. Credit enhancement can take various forms. During the same exercise an independent rating agency evaluates all aspects of the securitisation and asset-backed security issue and accordingly assigns a risk grading to the securitisation and asset-backed security issue. The rating agency assesses the securitisation and asset-backed security issue throughout the life thereof, at least once a year. The rating agency also rates the originator on a continuous basis. This determines the market trading price of the asset-backed security paper after the securitisation and asset-backed security issue has been conducted [1.3 & 1.4].

2. The special purpose vehicle raises the required funds, to take transfer of the pooled loan assets from the originator, by issuing asset-backed securities to investors.

3. The proceeds that result from the issuing of asset-backed securities are paid over to the originator who obtains "fresh" cash for new lending activities. The balance sheet of the originator has been restructured.

4. The originator continues to collect payments [4.1] on behalf of the special purpose vehicle from the debtors constituting the underlying loan assets that have been pooled, securitised and asset-backed. For this the special purpose vehicle pays to the originator a certain predetermined percentage service fee based on the value of the payments are administered by the originator on behalf of the special purpose vehicle. The special purpose vehicle may reinvest the cash flows [4.2], collected by the originator, in other interest bearing investments to enhance the total yield earned for security holders, or depending on the original arrangements contracted at the time of securitisation and the nature of credit enhancement, these cash flows may also be disbursed to security holders.

5. Normal coupon payments (the interest regularly paid to security holders based on the rate of interest stipulated on the asset-backed security paper) may also be paid from reinvestment activity. The coupon is the nominal interest that the asset-backed security attracts throughout its life until maturity. The coupon is payable in terms of the securitisation and asset-backed security agreement entered into between the special purpose vehicle and investors, governed by a prospectus.

Source: Compiled from "Make the most of your assets" (Corporate Finance, 1994)

Securitisation need not only be applied to the financial assets of financiers and banks, but can also act as a mechanism of lending facilitation in creative new situations. For example a financier could purchase the future cash flows of, for instance, a future stream of artistic royalties. During 1997 David Bowie successfully securitised his record royalties into 10-year asset-backed securities. Internationally this tendency appears to be the latest application of securitisation. Securitisation has also found application in shifting insurance and re-insurance risk through "Act of God" bonds.

3. SECURITISATION IN SOUTH AFRICA

In South Africa however, securitisation and asset-backed securities are not widely utilised by banks and financiers. Tensfeldt, Firer and Bendixen (1993) tested the perceptions regarding securitisation amongst South African bankers. The study revealed that, at that time, the costs of establishing a securitisation and asset-backed security structure did not justify the effort. It was also felt that the most important obstacle was the rate of acceptance by South African investors of asset-backed securities as comparable and liquid

investment alternatives. It is argued that these perceptions still prevail and are complemented by other obstacles that fuel stagnation.

Although two securitisations have been conducted in South Africa in the past, this did not pave the way for large scale development. The combined value of these issues amounted to R335 million. The former United Building Society Ltd securitised R250 million of its mortgage book, during 1989, into 20 year mortgage-backed debentures. Sasfin (Pty) Ltd, a subsidiary of Sasfin Holdings Ltd, a company listed on the Johannesburg Stock Exchange, conducted three securitisation and asset-backed security placements with a combined value of R85 million.

Towards the end of 1997 the National Housing Finance Corporation showed initiative and announced that it will embark on a programme of investigating the possibility of utilising securitisation in structuring funding for housing aimed at the middle- and lower income markets of S.A. (Chalmers, 1997).

In South Africa similar opportunities exist to those overseas and the market for facilitation by means of

securitisation is huge. For example the medical industry faces cost escalations beyond the inflation average and could benefit from securitisation. This market alone extends beyond R15 billion in annual cash flow. By the same token the broadcasting industry could generate substantial cash required for future high-tech developments. The annual cash flow of the subscription television industry amounts to more than R1,6 billion. Internet service providers who face stiff competition in continuously delivering faster and better technology could also benefit from securitisation by securitising their annual subscriptions which is estimated at R63m per annum.

Two questions thus emerge:

- Why is securitisation not actively being practised in South Africa?, and
- If market potential does exist for securitisation and asset-backed securities, what prevents development along the lines observed internationally?

In answering these questions, it is necessary to look at the environment characterising securitisation and asset-backed securities in South Africa. In broad terms, the problems stemming from the environment can be classified into problems relating to the market itself [soft issues] and legislation that governs the environment and the market [hard issues].

3.1 The environment for securitisation and asset-backed securities in South Africa

Although South Africa possesses rating agencies, their ratings of investment paper are not as yet accepted by investors as the driving force characterising investment decisions. Investors prefer to invest in paper issued by listed entities with established track records. Thus investors appear reluctant to invest in paper issued by newly established special purpose vehicles which may be set up to manage the securitisation process. Internationally, however, investors are prepared to invest in asset-backed securities solely on the basis of their ratings.

The South African financial sector is characterised by majority shareholders who are corporate conglomerates themselves. Structurally this promotes greater accessibility to capital compared to the raising of capital through securitisation. Adding to this is the tendency amongst South African banks to measure competitiveness in terms of size, with the resulting reluctance to shrink on-balance sheet lending assets, the consequence of securitisation. Internationally however competitiveness is a function of profitability rather than size. The banking industry as a whole is adequately capitalised in terms of bank legislation and thus does not need to securitise in order to improve its capital adequacy ratios.

Finance companies other than banks can benefit from securitisation since they can reduce their funding costs and are not bound by capital requirements as is the case with banks. On the other hand [as will be elaborated later in the article], in terms of current securitisation legislation, they cannot securitise directly. Their ability to absorb the high costs associated with securitisation, especially with mortgage securitisation, is not widely known.

The costs associated with securitisation are high. No cost ceiling is applicable on transfer of title within mortgage securitisation, with the result that these costs increase with an increase in the value of the securitisation and doubles where the mortgages are transferred to an originator and then securitised. The securitisation of other receivables and lending assets discloses the same cost profile associated with transfer of title within conventional debtor factoring, where costs are limited.

The South African investment market is characterised by mainly large institutional investors who also operate within legislative frameworks in making safe investments on behalf of their clients. Without their acceptance of asset-backed securities as viable investment alternatives, it is difficult to create a secondary market for securitisation and asset-backed securities.

Internationally, more than one credit insurance underwriter is evidently involved, which increases the amount of risk that can be absorbed at any one time. South Africa possesses one credit underwriter, Credit Guarantee Insurance Company, who provided the required credit enhancement to Sasfin Asset Securitisation Ltd. [Sassec 201 (Pty) Ltd, the second securitisation vehicle used in the Sasfin securitisation, employed primary credit enhancement through subordinating one class in favour of another].

Securitisation in emerging markets has shown steady development in that securitisation is insurance wrapped in those countries. Applying credit enhancement in this manner proved to be the preferred manner for allowing institutional investors with risk limitations to invest in asset-backed securities within an emerging market securitisation. Moreover, internationally credit enhancement is more sophisticated, in that it is not limited to insurance wrapping only, but allows for innovative structuring thereby forming an integral part of the rating process. Rating internationally is advanced. It allows for real-time online system sophistication electronically linked to the financial markets and the trading behaviour of asset-backed securities. This will only evolve over time in South Africa as securitisation develops.

Securitisation calls for management information systems focusing on in-depth analysis of historic data in supporting the rating process. This in turn is linked

with securitisation pricing- and trading systems. S.A lacks such technological development. Internationally these systems are vigorously supported by standardised documentation supporting the pooled loan assets. In S.A documentation is confined to the

uniqueness of each financier and its relations with clients.

The South African securitisation environment is illustrated in figure 2:

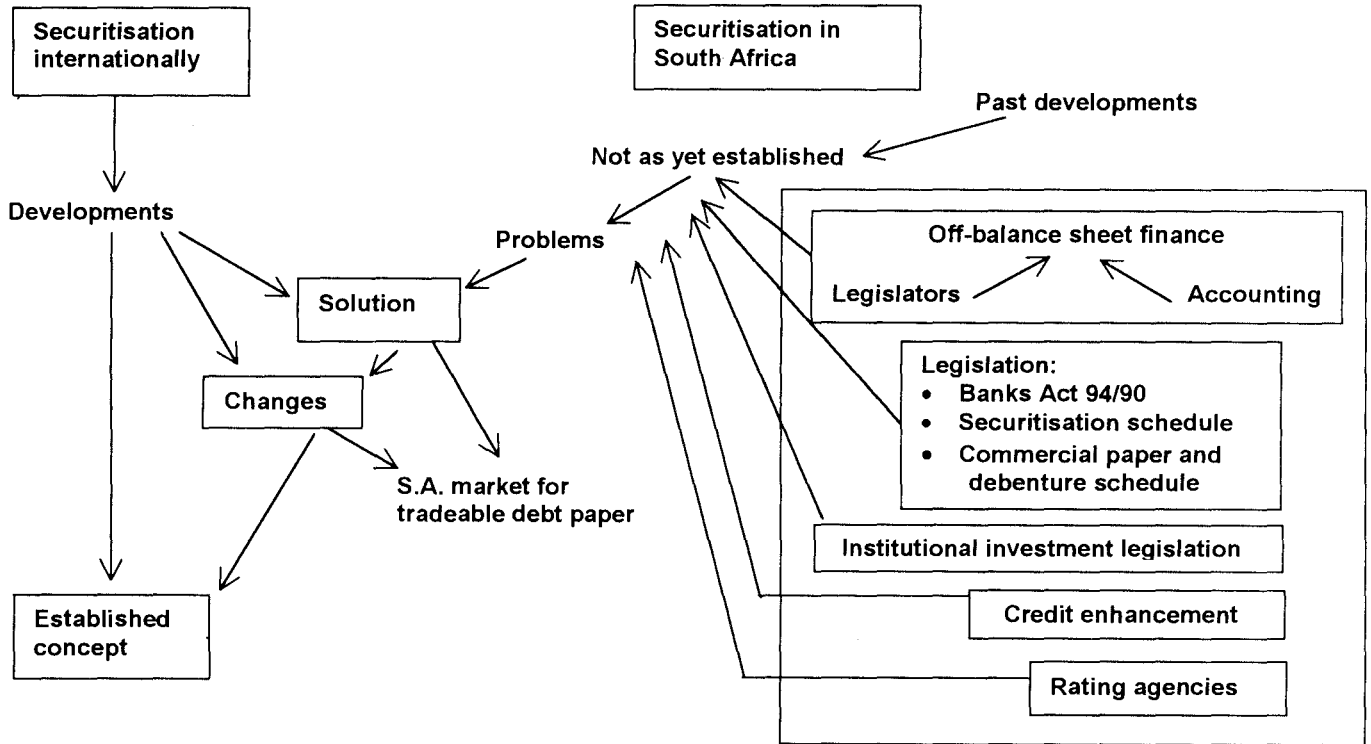


Figure 2: The South African environment of securitisation and asset-backed securities

Source: "Securitisation and asset-backed securities in South Africa"(Van den Berg, RAU,1997)

The more important [hard] issues hinge on legislation and accounting standards regulating the securitisation environment in South Africa.

The Securitisation schedule, notice 153 of 3 January 1992, was gazetted under paragraph cc within the Banks Act 94/90 [the Act] under the definition of the business of a bank. This section of the Act makes reference to items considered not forming part of the business of a bank. These items so listed do not imply that banks are prohibited from executing these activities as part of their business, but rather that these activities are not limited to banks only. This implies that finance companies and other entities other than banks may enter into a securitisation and asset-backed security issue provided that the conditions as stipulated by the mentioned schedule are fulfilled. However, on the other hand, the wording of the securitisation schedule makes reference to a bank as being the originator, and thus creates the perception that only a bank may originate a securitisation and asset-backed security structure.

Under the list of items that are not confined to only the business of a bank, is the issuing of debentures, provided that the proceeds are not redeployed in funding lending activities, in which case the issuing of debentures for that purpose is limited to banks only. The commercial paper and debenture schedule, notice 152 of 3 January 1992, also gazetted within the Act under paragraph cc, under the definition of the business of a bank, also have this limitation embodied within it. Hence a finance entity other than a bank is not permitted to issue debt paper to fund its lending operations. The special purpose vehicle is not registered as a bank and thus cannot issue debt paper, with the result that securitisation must be routed through a bank.

The requirements of the commercial paper and debenture schedule is at present the only guided reference for issuing asset-backed securities since separate asset-backed security legislation is not evident and the characteristics of asset-backed securities conform with interest bearing instruments covered by the said schedule. One of the requirements

of this schedule is that the issuer should have a net asset value of R100m.

Virtually only banks and corporate entities listed on the Johannesburg Stock Exchange have a net asset value of at least R100m, which makes the fulfilment of this condition by finance companies and other non-listed entities other than banks virtually impossible. On inception the special purpose vehicle created for the purpose of the securitisation usually does not fulfill the R100m net asset test, in which case a bank must endorse the issuing of debt paper. This requirement, too, is in contradiction with the securitisation schedule [where a bank is the originator], because it stipulates that the originator can not provide financial assistance to the special purpose vehicle, with the end result of a third party bank endorsing debt paper. In such a case the endorsement will attract a 100% risk weighting for the endorsing bank [such activity falls within the scope of off-balance sheet activities]. More so, the legislative denomination of debt paper is set at R1m which does not promote secondary market liquidity.

The definition of off-balance sheet finance within the Act has the same meaning as the definition of off-balance sheet finance as found within Accounting Standard 120 (AC 120). The meaning and definition of off-balance sheet finance has important implications for securitisation. Both classify off-balance sheet finance activity as situations where portfolios are managed on behalf of other parties, and where portfolios are being managed on behalf of other parties where financing is provided. AC 120 goes further, in that it also classifies activities relating to the replacement of credit as an off-balance sheet finance activity. Where securitisation is deployed as raising fresh cash for new lending activities, the replacing of credit is evident, which makes securitisation an off-balance sheet activity requiring full disclosure thereof as an off-balance sheet activity. The originator [bank] is familiar with logistical risk management in respect of the collection of payments from underlying debtors on behalf of the special purpose vehicle, which can be related to "managing assets on behalf of other parties", in other words "no clean break". Under this interpretation securitisation falls within the meaning of off-balance sheet activities and will require full disclosure in the financial accounts of the bank for purposes of calculating capital-adequacy and requirements.

From a legal point of view, the assets securitised, including the rights and obligations thereto (in some instances the rights and obligations can be separated from one another), are transferred to the special purpose vehicle at a predetermined price in terms of a legally binding agreement, which coincides with the law of contract and implies "clean break". From this point of view securitisation should be a true off-balance sheet activity, and, where a bank acts as facilitator to a special purpose vehicle, the assets so securitised by

the bank should not be included in risk weighted assets for calculating capital-adequacy and requirements (at present legislation requires that a bank acting as facilitator complies to the definition of off-balance sheet finance referred to above). True off-balance sheet interpretation is further evident from the Securitisation schedule, which requires that the originator [bank] is to be distanced from the SPV.

Off-balance sheet finance in the hands of a bank attracts a risk weighting of 100% for calculating capital adequacy. Should a bank, for instance, securitise a portion of its mortgage book, for which the risk weighting is 4% [where the value of the underlying asset exceeds the outstanding loan balance, and it is classified after securitisation as off-balance sheet finance, the capital requirements for the bank increases to 8%, due to a 100% risk weighting being applied to a bank's off-balance sheet lending.

In terms of the Act, an investment in asset-backed securities by a bank will impact negatively on capital requirements for the investing bank compared to the originating bank, which will gain in Rand value terms. The securitising bank already accounts for securitised assets in its capital adequacy determination prior to securitisation, whilst a bank investing in asset-backed securities still has to account for such investments in its capital adequacy determination. Thus, large scale investment by banks in asset-backed securities is derived from its surplus capital after accounting for capital requirements. This does not promote a secondary securitisation and asset-backed security market amongst banks. On the other hand, should a third party bank be involved in the securitisation as an underwriter, some benefits do exist as a result from underwriting activity in respect of capital requirements for calculating capital adequacy.

Internationally, countries facing similar legislative obstacles introduced amended legislation during 1994 aimed at promoting an active secondary market in securitisation and asset-backed securities. These changes included, among others, improved credit enhancement structuring allowing for a more active role by the originator and capped loss facilities pending securitisation circumstances.

4. CONCLUSION

Opportunities for securitisation in S.A. do exist. The secondary market potential exceeds R180bn. If one includes the potential securitisable size of mortgages within the lower and middle income earning groups, the market potential stretches beyond R300bn. Thus the volumes required for any secondary market in financial instruments are potentially present.

Through legislative change and higher awareness, a secondary market for securitisation and asset-backed securities can be created in S.A. Given the current

environment, it is possible to securitise receivables not constituting lending in the true sense of the word and definition. Such securitisation will not violate the limitation of issuing debt paper, since the proceeds are not deployed in normal lending activities, coupled to the underlying debtors not originating through a formal loan agreement. The opportunity lies in cash flow optimisation and improved risk management of the timing of income. Such securitisation hinges on the approach of separating underlying rights to future income from coinciding obligations.

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