Note on the impact of securitisation transactions on credit extension by banks

by N Gumata and J Mokoena

Introduction

Securitisation is still at an early stage of development in South Africa, but has grown rapidly in recent years. The objective of this note is to introduce briefly the concept of securitisation, and to outline and quantify the impact of securitisation transactions on the credit aggregates released by the South African Reserve Bank (Bank).

The concept of securitisation[1]

1 *For a more detailed discussion, the reader is referred to the sources listed at the end of this note.*

Securitisation is defined as the process by which a company converts various assets on its balance sheet into marketable securities which can then be sold to investors and traded in the capital markets.

A securitisation issue is usually structured by an arranger, and involves three key steps: *Firstly*, the company that originally owns the asset (the originator) sells them to a newly formed company or trust known as the issuer; *secondly*, the issuer issues securities (either bonds or notes) secured by the cash flows of the underlying assets; and *thirdly*, the securities are purchased by investors, usually institutions, who either trade them or place them in their investment portfolios.

With securitisation transactions the transfer of rights to an asset can take one of two forms, namely traditional or synthetic securitisation.

2 *A special purpose vehicle in this context is defined as a company incorporated or a trust created, insolvency-remote from the institution transferring the assets in terms of a securitisation scheme, and solely for the purpose of the implementation and operation of a securitisation scheme.*

A *traditional* securitisation scheme involves the legal and economic transfer of assets to a special-purpose vehicle [2] (SPV) issuing asset-backed securities that are claims against a specific asset pool. In such a scheme, different classes of asset-backed securities may be issued, and each class has a different priority claim on the cash flows originating from the underlying pool of assets. Under a traditional securitisation scheme a true sale takes place and all rights and obligations are transferred to the SPV. This is the type of securitisation scheme that typically affects the measurement of the bank credit aggregates.

3 *A credit derivative instrument is any contract in terms of which the credit risk (default risk) associated with a financial asset is isolated from the other risks associated with that financial asset and which credit risk is transferred from one counterparty (the protection buyer or credit risk seller), to another counterparty (the protection seller or buyer of the credit risk).*

4 *Credit risk is the risk that a counterparty to a financial obligation, such as a loan, will default on repayments linked to the obligation. Market risk is the risk that the market price of an asset may change, which may result in a loss to the reporting bank on realisation of that asset.*

A *synthetic* securitisation scheme, on the other hand, refers to a structured transaction whereby an institution uses a portfolio of credit derivative instruments[3] to tranche and transfer the credit risk and/or market risk[4] associated with a specified pool of assets to the SPV. The resulting credit exposures have different levels of seniority. Under a synthetic securitisation scheme, the underlying assets are not necessarily moved off the originator's balance sheet.

Motives underlying securitisation

The potential benefits of securitisation to the originator include, among other things, the following:

1. *More efficient financing and profit maximisation.* Securitisation may be used to lower the firm's weighted average cost of funds. This is possible as highly rated debt can be issued into capital markets with strong investor demand driving down financing costs.

2. *Improved balance sheet structure and financial ratios.* Securitisation can enhance managerial control over the size and structure of a firm's balance sheet. For example,

accounting de-recognition of assets (i.e. removal from the balance sheet) can improve gearing ratios as well as other measures of economic performance such as return on equity, and in a banking environment can also curtail costs attached to bank intermediation such as those arising from cash reserve requirements.

3. *Improved risk management.* Securitisation often reduces funding risk by diversifying sources of funds. Financial institutions also use securitisation to eliminate interest rate mismatches.

4. *Lower economic and regulatory capital requirements*. Securitisation also releases capital for other investment opportunities. This may generate economic gains if external borrowing sources are constrained, or if there are differences between internal and external financing costs.

Securitisation of bank loans and its impact on the monetary and credit aggregates

When securitisation transactions occur, particularly traditional securitisation schemes, assets are transferred from the balance sheet of the originating bank to a SPV. These assets are typically loans which, while still on the bank's balance sheet, would be included in the measured level of credit extension to the private sector by the monetary sector as released by the Bank. While SPVs are usually created by banks, they are classified as *other financial intermediaries* in the monetary and financial statistics, which makes them part of the other private-sector financial institutions and not the monetary sector. SPV assets are therefore excluded from the calculation of credit extension by the monetary sector. Likewise, SPV liabilities are not liabilities of the monetary sector and therefore cannot form part of the monetary aggregates. What typically happens is that the SPV issues securities which are purchased by institutional investors. The institutional investors typically buy the securities by drawing down their deposits with banks, such deposits having formed part of the broadly defined money supply, M3.

The overall effect of securitisation is therefore likely to be a reduction in the level of credit extension by the monetary sector and a reduction of similar magnitude in the M3 money supply. In essence, the banking sector would have collapsed its balance sheet by setting off some loans against some M3 deposits. However, the original borrowers still have obligations (but to a SPV, not to a bank), and the institutional investors still own assets (but these are now tradable securities, not M3 deposits).

Magnitude of securitisation transactions involving domestic banks

Although securitisation is still at an early stage of development in South Africa, it has grown rapidly in recent years. The accompanying table shows that issuance by private banks has increased from R250 million in 1989 to a cumulative total of R26,0 billion by the end of October 2005. Synthetic securitisation transactions have grown to account for no less than 40 per cent of the total amount of transactions undertaken by the private banks in recent years, but traditional securitisation schemes remain quantitatively more important.

Table 1: South African banks' securitisation transactions

Issuer	Assets securitised	Value R million	Originator	Arranger	Period
Traditional securitisation or asset-backed securitisation					
United Building Society Ltd	Residential mortgage loans	250	United Building Society	United Building Society	Nov 1989
Sasfin Asset Securitisation (Pty) Ltd	Equipment leases	60	Sasfin Bank	Sasfin Bank	Jun 1991
Private Mortgages 1 (Pty) Ltd	Residential mortgage loans	1 000	Investec Bank	Investec Bank	Dec 2002
Private Mortgages 2 (Pty) Ltd	Residential mortgage loans	1 400	Investec Bank	Investec Bank	Nov 2003
Collateralised Auto Receivables Securitisation (CARS) 1 (Pty) Ltd	Instalment sale agreements	3 000	Absa Corporate and Merchant Bank (ACMB)	Absa Asset and Vehicle Finance	Nov 2003
Equipment Rentals Securitisation No 1 (Pty) Ltd (ERS)	Equipment leases	670	Sasfin Bank	Sasfin Bank	Nov 2003
Accelerator fund 1	Motor vehicle loans	3 000	Standard Bank	Standard Corporate and Investment Bank	Sep 2005
Blue Granite Investments No 1	Residential mortgage loans	4 500	Standard Bank	Standard Corporate and Investment Bank	Oct 2005
Synthetic securities					
Firstrand 2000A	Credit card – Future Flows	1 800	FirstRand Bank	Rand Merchant Bank/Credit Suisse First Boston	Jun 2000
RMB CDO 1 Ltd	Corporate loans Collateralised Debt Obligation (CDO)	3 900	Rand Merchant Bank	Rand Merchant Bank/Morgan Stanley	Sep 2000
Kiwane	Corporate loans Collateralised Debt Obligation (CDO)	500	Gensec/Real Africa	Gensec/JP Morgan	Aug 2000
RMB CDO 2 Ltd	Corporate loans Collateralised Debt Obligation (CDO)	2 900	Durolink Rand Merchant Bank	Rand Merchant Bank/Goldman Sachs	Aug 2001
Procul Ltd	Instalment sale agreements	1 960	FirstRand Bank and Wesbank	Rand Merchant Bank	Jun 2002
Lexpub 15 Investment Ltd ta Fresco 1	Corporate loans Collateralised Debt Obligation (CDO)	1 082	FirstRand Bank	Rand Merchant Bank	May 2002

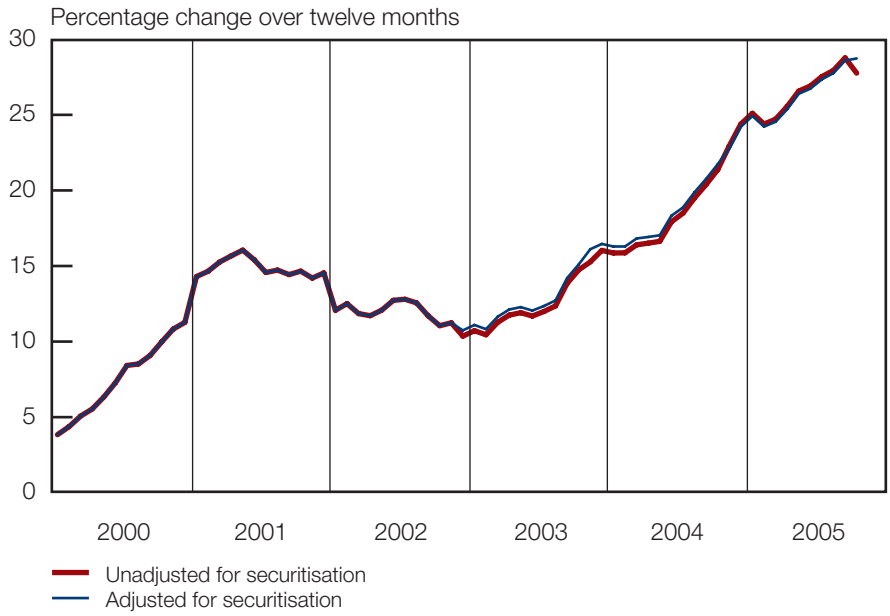
Source: ACMB Captial and Debt Markets, 2005; Van Vuuren, 2004

Table 2: Credit aggregates unadjusted and adjusted for securitisation transactions

	Mortgage advances	Mortgage advances adjusted for cumulative effect of securitisation	Instalment sale and leasing advances	Instalment sale and leasing advances adjusted for cumulative effect of securitisation
	(R billions)			
2002: Jan	261,0	261,0	95,7	95,7
Feb	265,0	265,0	96,7	96,7
Mar	266,4	266,4	98,5	98,5
Apr	268,6	268,6	99,2	99,2
May	271,9	271,9	101,1	101,1
Jun	274,9	274,9	101,9	101,9
Jul	277,8	277,8	102,7	102,7
Aug	280,3	280,3	103,9	103,9
Sep	280,0	280,0	104,2	104,2
Oct	281,8	281,8	105,6	105,6
Nov	284,8	284,8	107,6	107,6
Dec	286,0	287,0	108,0	108,0
2003: Jan	289,0	290,0	109,0	109,0
Feb	292,7	293,7	110,9	110,9
Mar	296,5	297,5	111,7	111,7
Apr	300,1	301,1	113,9	113,9
May	304,3	305,3	116,2	116,2
Jun	307,1	308,1	117,0	117,0
Jul	311,1	312,1	118,5	118,5
Aug	314,9	316,0	120,6	120,6
Sep	318,7	319,7	122,2	122,2
Oct	323,3	324,3	124,3	124,3
Nov	328,3	330,7	123,3	127,0
Dec	331,8	334,2	126,4	130,0
2004: Jan	334,8	337,2	127,3	131,0
Feb	339,1	341,5	129,4	133,1
Mar	345,1	347,5	131,9	135,6
Apr	349,7	352,1	133,2	136,9
May	354,9	357,3	135,5	139,2
Jun	362,1	364,5	137,9	141,6
Jul	368,6	371,0	140,3	144,0
Aug	376,3	378,7	142,5	146,2
Sep	383,7	386,1	145,6	149,3
Oct	392,4	394,8	148,8	152,4
Nov	403,7	406,1	150,6	154,2
Dec	412,8	415,2	152,5	156,2
2005: Jan	418,9	421,3	154,6	158,2
Feb	421,9	424,3	156,7	160,3
Mar	430,4	432,8	159,1	162,8
Apr	439,0	441,4	161,5	165,1
May	449,2	451,6	164,3	168,0
Jun	459,5	462,0	167,0	170,6
Jul	470,0	472,4	169,8	173,5
Aug	481,5	483,9	172,9	176,6
Sep	494,1	496,5	173,3	180,0
Oct	501,3	508,2	176,1	182,8

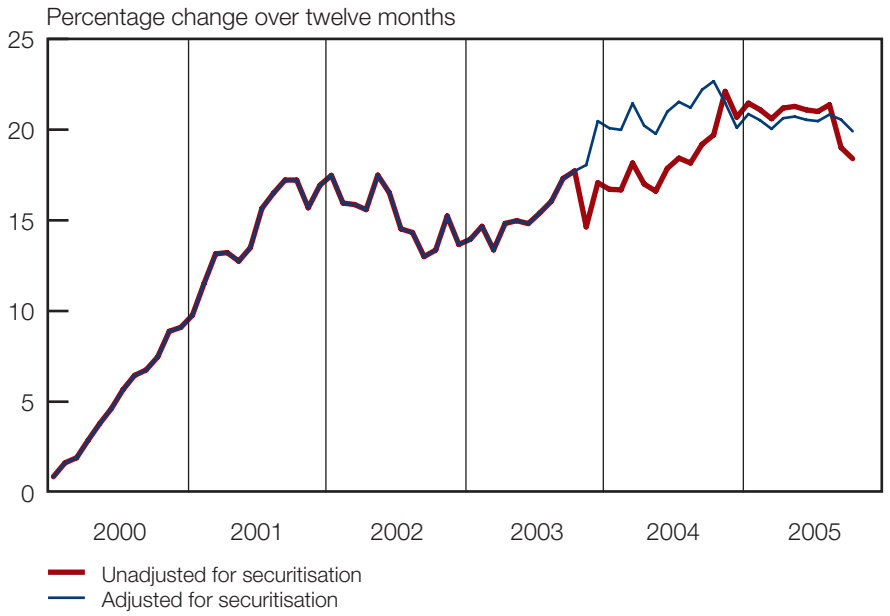
A graphic comparison of twelve-month percentage changes (see Graph at top of following page) shows that growth in mortgage advances adjusted for the cumulative effect of securitisation transactions is generally quite close to that of the measure that is unadjusted.

Mortgage advances



However, in the case of instalment sale and leasing transactions, more significant differences may be observed between the recent twelve-month rates of growth in the measures adjusted and unadjusted for the cumulative effect of securitisation transactions, as shown in the Graph.

Instalment sale and leasing finance



Conclusion

Securitisation activity in South Africa expanded rapidly in recent years. Where banks engage as originators in traditional securitisation transactions, it is likely to result in a

reduction in both bank credit extension and M3 money supply. In interpreting short-term changes in the credit aggregates and money supply, it is helpful to take securitisation activity into consideration. However, it should be noted that this is only one of a multitude of mechanisms through which disintermediation and reintermediation take place continuously, thereby reducing or expanding the balance sheet of the monetary sector.

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