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Article

Ukrainian securitization : to be or not to be?

Economy and forecasting

Provided in Cooperation with:

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Reference: Volkov, Serhii (2019). Ukrainian securitization : to be or not to be?. In: Economy and forecasting (2), S. 153 - 159.

<http://econ-forecast.org.ua/?>

[page_id=189&lang=uk&year=2019&issueno=2&begin_page=153&mode=get_art&flang=en](http://econ-forecast.org.ua/?page_id=189&lang=uk&year=2019&issueno=2&begin_page=153&mode=get_art&flang=en).

This Version is available at:

<http://hdl.handle.net/11159/6921>

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Serhii Volkov¹

UKRAINIAN SECURITIZATION: TO BE OR NOT TO BE?

The sad statistics of attracting foreign investments in Ukraine in recent years is far from being primarily caused by the belligerences in the east of the country or adverse economic conditions. Actually, there are a number of other risks due to which investing in Ukraine is considered as unacceptable. And those risks are associated exactly with investor's insecurity.

Are there financial instruments able to protect investors from unfair treatment of their money by borrowers? How can cash flows from invested assets and facilities be channeled directly to the investors, bypassing compromised Ukrainian banks and corporations? How exactly can the assets be protected from raiding and misappropriation of the cash they generate?

Professional investors have long learned to manage market risks such as price, interest, exchange rate, liquidity, credit ones and more. Using statistics, technical analysis, and various behavioral market models, they are now able to select markets and investment tools according to their "risk appetite".

Thus, overcoming the non-market risks is the main task for the Ukrainian Parliament, the Government and other state institutions such as the NBU, and National Securities and Stock Market Commission (NSSMC).

In business and law, of wide use is the two-man rule (vier-angen-prinzip, two-man rule), or four eyes principle, according to which the decision can be made on the consent of two or more mutually independent persons. This approach prevents corruption, financial abuse, misuse of funds and the use of official position for personal purposes. And is it possible to apply this "four eyes" principle to the relationship between the originator who uses the funds from the securities market and his creditors? In a market where investor lenders are a wide range of unknown securities holders?

Yes, it is, with the use of the advanced financial technologies and stock instruments globally known as securitization.

Securitization is a way of attracting investments by placing securities that are repaid by future cash inflows from assets whose rights are assigned and serve as a source of future settlements with the investors (the securities' owners).

As a result of securitization, the chain of payments from the beginning of investing to the repayment of the debt is deprived of its weakest link, that is, the Ukrainian originator - the person who attracts the investment funds without being trusted by the investors. He is deprived of the influence not only on assets, but also

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of that on the cash flow they will generate in the future. This way of attracting may be of interest to the most powerful investors, who, having long-term resources, do not want (cannot) take risks. Moreover, without the use of the securitization mechanism, structural reforms in the pension sector cannot be initiated because of unacceptably high risks of theft and fraudulent impairment of long-term savings.

The lack of investor confidence can be offset with a reduction in the impact of subjective factors, by replacing them with a modern financial securitization mechanism based on the protection of settlement sources and high-quality distribution of functions and powers among professional participants of the process. That is, the return on investment will not depend on the behavior and unfair treatment of local counterparties.

First, assets must be separated from the originator's other assets. Such a person should be prevented from interfering with or obstructing cash flows towards investors. This is to be attained with the creation of a special purpose vehicle (SPV) in the form of a non-business partnership to which the ownership of the assets is transferred. Investments are made through the purchase of the SPV securities that are secured by these assets.

Actually, such an SPV serves as an asset segregation facility, i.e. it is a separate balance sheet that will account for pooled assets and liabilities to investors after the originator has received the investment funds for the pooled assets. The legal form of creating a special issuer company (SPV) is not very important (in different jurisdictions it may be a foundation, a company, etc.), because it is not a legal entity in the traditional sense. It is created for a separate issue and terminated immediately after the end of circulation of the securities, and its only function is asset balancing.

It is clear that no one but the securities' owners can claim these assets, and the company itself cannot be bankrupted. SPV's activities (emission organization, asset accounting, payment collection, submitting financial statements, etc.) are performed for a commission fee by unrelated legal entities (in the same way as accounting and legal outsourcing), some of which should be escrow banks and financial trust companies.

Secondly, all funds from the assets will be transferred to an escrow account opened at the servicing institution (a bank that exclusively provides paid services for collecting payments from assets). These funds can only be written off for their intended purpose, that is, for the benefit of investors who hold the securities. This mechanism is provided by a specialized financial management company that provides commission services, including organization of securities issues, reporting and accounting, etc. Securitized assets are legally protected against confiscation and seizure. After the securities are repaid and calculations are made, the SPV ceases to exist.

Thirdly, management of the assets in the interests of investors for remuneration is carried out by a professional legal entity specified in the issue's terms, which is not related to the manager. This ensures a clear separation, between non-related parties, of the functions of the management of assets and cash flows, which is, in fact, an application of the "four eyes" principle for preserving the funds and securing the assets.

Fourthly, the rights and powers of professional participants of the securitization, that is, organizer, manager, servicing institution (reserve servicing institution), and the auditor (who confirms the compliance of their actions) are fully established by the law and the terms of the securitization. Their violation is a criminal offense.

Fifthly, investors can define the degree of their risk, and, according to it, calculation is made of the yield on the selected specific tranches (series) of securities that are determined by the probability of cash flow. Such distribution of issue is attained via structuring cash flow by risk based on the rating agency's professional opinion.

Forecasting is based on statistics on the securitized pool of assets and other data in accordance with a public methodology approved by the regulator. The result of the forecast of future cash inflows serves a basis for the rating of the individual subordinated series: the highest one - for the senior series (in the volumes of the most probable earnings), the slightly lower one - for the subordinated series (by which additional guarantees can be raised for the rating increase) and the lowest series (in the amount of forecasted loss) that remains (as a result of the initial placement) with the originator and will not circulate on the market.

With the adoption of appropriate legislation that extends securitization to non-mortgage assets (mortgage securitization is already regulated by the Law on Mortgage Bonds), economic development can significantly boost the inflow of investment in certain industries and projects. The practical aspects of securitization can promote investment, particularly in infrastructure funding. Incentives to attract investment in long-term projects for the development of transport, energy, housing and communal infrastructure and social infrastructure can be implemented by launching infrastructure bonds, for which the fulfillment of obligations is actually secured by the assets generated for the borrowed funds and then generate payment for usage, subscription payments, fees etc.

If investors become sure in the fair distribution of fees for the usage, for example, of a toll road, and in the long-run protection of their level, then it becomes possible to attract funds for the construction of that road as public-private partnership.

Such attraction is performed by placing one of types of securitization tools, which is infrastructure bonds. In this case, there is no need to obtain government guarantees and pledge state and municipal property, because the source of repayment to creditors is part of the funds received from drivers less operational costs necessary for the road's proper functioning.

If the level of payment is pegged to specific market indicators (such as consumer price indices), then it is possible to use that mechanism to raise funds for long periods of 10-20 years. It is interesting that most of such securities are bought out by the managers of accumulative pension funds whose priorities are low risk and confidence in the protection against asset impairment.

Bank detoxification. Owing to the securitization of toxic assets (NPL), banks not only get rid of bad debt (replacing it with bonds), but also get opportunities to effectively control all debt collection processes (while continuing their servicing). At the same time, the bank gets completely rid of long burdensome procedures that precede the write-off of bad assets from the balance sheet. The originator bank is



able to repay some of the money in case of a discounted sale, to investors, of the senior series of subordinated bonds whose amount is calculated as the most probable income from the assets. Freeing banks from toxic assets is a prerequisite for resuming bank lending.

Using securitization of monetary claims would facilitate large-scale funding of the real sector, in particular, housing, local industry, energy saving etc. In addition, it is able to protect against plunder and depreciation of pension savings after the implementation of pension reform.

Ukraine already has a sufficient experience in securitization: a certain legislative and regulatory framework on mortgage securitization has been developed. With the adoption of the Law on Mortgage Bonds in 2005, several issues were made and repaid, in particular the Housing Refinancing Agency (ARZHK) has already implemented two successful issues of mortgage-backed securities in the amount of UAH 500 million, which were timely repaid.

ARZHK possesses valuable practical experience in issuing and maintaining covered bonds. It has prepared a professional staff and information technologies that optimize the formation and accounting of security pools from a large number of assets, in compliance with information protection requirements that are the functions of a trusted organizer. Such experience would be useful for extending securitization to non-mortgage assets, such as consumer loans and small business, leasing agreements, homogeneous accounts receivable and monetary claims (license fee, utilities payment, and other fees), etc. This becomes possible with the adoption of Draft Law No. 2784 "On Bonds Secured by Pooled Assets".

Countries, where securitization legislation and the secondary circulation of bank loans on the securities market are operating, have a rapidly growing inflow of investment in various industries. Central banks use mortgage and real-sector securitization as an incentive for economic growth, buying out pooled securities under various programs, such as the ECB's "quantitative easing" program.

The Russian Federation has even introduced a "factory of MBS's" (mortgage-backed securities) - a universal SPV for securitization of mortgage loans, due to which Russian public banks easily bypass the sanctions imposed against them as to the access to long-term borrowings on the international market. Moreover, mortgage securitization has enabled the RF Government to save budget funds and abandon the previous practice of public subsidizing of mortgage rates. Owing to the fundamental decrease in the cost of attracting long-term credit resources from the international securities market, market interest rates for mortgage loans issued by Russian government and commercial banks fell to 10% per annum.

A similar technology of cyclical mortgage refinancing via securitization in Ukraine was initiated with the creation of ARZHK (prototype of the Russian mortgage institution) more than five years ago, but the project was never completed. Issues of ARZHK mortgage bonds were suspended. It is proposed to turn the ARZHK into a company for the management of bad credits accumulated in state-owned banks. According to the government's plan, this company is to buy out bad corporate loans and settle problematic debts that banks have not coped with. Thus,

it has become the norm to solve all problems at public expense instead of attracting private investment.

As of today, Ukraine cannot attract investors with the help of any usual financial instruments, such as bank deposits, corporate (unsecured) bonds, MIF certificates (often scheme-based ones), corporate stocks, and the like. Instead, loan securitization and infrastructure bond issues, once planned for launch in 2016, have disappeared from the recently updated Comprehensive Program for the Financial Sector Development of Ukraine until 2020. It is clear that OVDPs and NBU deposit certificates are not market-based tools as to investing in the real sector.

Globally, asset securitization has also become an important source of liquidity for corporations. Since the end of the last century, the treasurers of large corporations, especially service providers like heat utilities, have been using a specific method of financing, which is an interesting alternative to bank loans and attracting capital investments.

Recently, this approach has become available to middle and even non-investment companies. In the USA alone, the issue of asset-backed securities exceeds 4 trillion USD. It is also a popular method of financing in Europe, where annual emission of collateralized assets exceeds 240 billion euros.

In Ukraine, the absence of such an opportunity for Ukrainian companies (due to the short sighted attitude of MPs, the government and financial regulators) is already causing acute systemic problems, in particular, the inability for the government and large commercial corporations to timely repay bank loans. And one can't even think about alternative debt financing and attracting investments.

Owing to securitization, the receivables of numerous consumers of services including utilities, heat, water, various subscriptions, leasing, credit cards, consumer loans, etc. are transformed into such a convenient payment tool as securities. This extraordinary transformation enables companies not only to timely pay off their lenders, but also to raise necessary funds on the capital markets.

This effect is attained due to the peculiarities of financial assets that can be imagined as future cash flow from numerous payers, that is, these assets will sooner or later be converted into a certain amount of funds. What that amount will be depends on the debt's quality, which can be revealed based on retrospective statistics of past settlements. Moreover, this can be done quite accurately, it is even possible to determine within what period and how much money will come, how much will be forcibly collected, and how much will be hopelessly lost (there are many mathematical techniques and computer programs for this purpose).

Owing to the securitization of receivables, all future cash flow from consumers is directed to the benefit of the owners of the securities whose collateral is the receivables themselves, which corporations sell in advance to a specially created legal entity, which is the issuer of such securities. That is, corporations receive all the earnings from the sale of securities at the market price (at a discount relative to the balance sheet value of the assets) in exchange for waiving their right to receive all future payments from consumers. Instead, they may continue to collect payment, but for a commission fee.



It is clear that all funds will no longer come to current corporate accounts, but to special escrow accounts opened by agent banks. Funds on behalf of specialized financial intermediaries (trusts) will be periodically distributed for intended purposes: to the securities' owners, and as commission payments for the collection of payments and provision of other services. It is also clear that not all securities will be repaid: this applies to consumer defaults.

For a fair distribution of future cash and the risk of loss, the issue of securities is structured by priority in the calculation of individual tranches (series): the senior series - in the amount of expected cash and the younger series - in the amount of predicted untimely and repayments of doubtful debts whose yield will be somewhat higher relative to the risks. Separate series of securitized items may be additionally provided with guarantees and other means of minimizing investment risks.

There is a common mistake to consider securitization a form of debt borrowing, which is not surprising due to numerous similarities between the two forms of financing. Key similarities between bond borrowing and securitization include the following:

Firstly, corporate debt and securitization programs are eventually implemented through raising funds on the capital markets via the issuance of debt securities. But in the case of securitization, the SPV is the nominal debtor, which represents the pooled accounts receivable (and has no other assets), i.e. the issuer's risk is zero, and the remaining risks are associated with the assets. At the same time, in the case of bond borrowing, the risk of the financial condition (bankruptcy) of the corporate issuer is a key factor.

Secondly, the value of bond borrowing as with securitization (coupon's fixed/floating rate or discount), is calculated based on market indicators.

Thirdly, securitization, like bond borrowings, does not change the size of shares for shareholders and company founders.

Fourthly, securitization programs are carried out by the same professional participants of the capital market who organize other forms of debt financing, namely, commercial and investment banks, specialized financial companies, rating agencies, etc.

Fifthly, the funding volumes available under both securitization and bond borrowing are based on a certain amount of circulating assets, which are limited by negative expectations about the risks of reduced earnings and other negative factors.

However, defining securitization simply as a separate type of debt financing is not appropriate because there are significant differences between the two notions since securitization entails a real genuine sale of assets by a seller (corporation) to a buyer (SPV), which has numerous implications incompatible with the definition of securitization as ordinary debt:

– *first*: securitized assets are removed from the balance sheet of the seller company. It's not just an accounting trick to hide assets, it's a true reflection of the fact in the accounting and financial statements that those assets were actually sold and no longer belong to the seller company. From the moment of sale, the company will no longer own the legal rights to the assets, together with all types of collateral;

– *second*: in the case of debt borrowing, the company must timely repay the debt regardless of the state of payments with consumers and counterparties, and the amount it has to pay does not depend on the actual cash revenues from receivables. While during the securitization, the issuer (SPV) bears no liability for repayment of the debt to the holders of certain series of securities beyond the amount of actually collected payments, cash reserves or guarantees (if any);

– *third*: unlike debt borrowing, the circulation of pooled securities is not interrupted by the issuer's (SPV's) default or bankruptcy. Although there are objective circumstances through which securities repayment may be delayed, in particular, as a result of a decrease in level of cash collections on securitized accounts receivable, in any case it does not mean any bankruptcy or default.

Instead, with bond borrowings, in case of issuer's bankruptcy, bondholders find themselves at the end of the creditors' chain. In addition, with debt borrowing, cash flow goes from one account to another that belong to different entities (distributors, companies, servicing banks, etc.) each next of whom increases his risks. In the case of securitization, funds are credited and accumulated for settlements on special escrow accounts opened by the escrow agent bank. These funds are not included in the liquidation mass and are exclusively purpose oriented;

– *fourth*: unlike traditional forms of borrowing, such as bank loans, the company not only diversifies its sources of funding through securitization, but also gets rid of its dependence on the financial position and sudden change in its creditors' policies.

These fundamental differences between securitization and common debt can provide significant benefits to the companies' financial strategies by launching effective mechanisms for the management of risk, capital and liquidity.

By monetizing, through securitization, significant balance sheet assets, companies get the opportunity not only to reinvest funds in their business, but also to get rid of their other "inconvenient" debts to the banks by paying them from the proceeds of the sale of securities or even by the securities themselves (by achieving a corresponding agreement with creditor banks). This considerably reduces the company's financial risks associated with bank financing when a bank, under the decisions of a credit committee, or under the influence of its own regulatory environment, or even as a result of a minor breach of the credit agreement on company's part, may deprive it of financing by artificially creating a liquidity crisis for it.

In Ukrainian realities, the presence of such instruments as securitization in the possession of banks and corporations can fundamentally improve market liquidity by speeding up settlements, and facilitating medium-term non-capital investments. It can also held significantly reduce debts to creditors, including state monopolies' debts to public banks, which would reduce their need of additional capital thus reducing the burden on Ukraine's the central government budget.