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On Securitization of International Syndicated Loans

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Abstract

Since 80s, along with the heating-up competition in finance industry and the liberalization trend of financial supervision, a tendency of integration appears in world three financial service fields, namely banking, insurance, and security. It threats the banking business. The banking industry that always possesses the core position in financial system faces enormous challenges. On the other hand, all countries regulate standard rate of interests for commercial banks' deposits and loans. Therefore, the margin between banks' assets and liabilities is limited, which leads to more fierce competition among banks. Under this background, the securitization trend serves as a bridge between direct financing and indirect financing, creating more opportunities for banks reducing costs and increasing profits, and improving banks' competence. Starting from international syndicated loans, this paper analyzes the primary mode and the advanced mode of international syndicated loans' securitization, compares their characteristics, and further studies reasons for securitization of international syndicated loans.

Keywords: International syndicated loans, Securitization, Financial innovation

International syndicated loans mean the borrower, in form of mandate letters, ask the leading bank to organize the bank syndicate and provide with loans for them. The traditional ways, namely the most fundamental ways, are: direct participation (or loan syndication) and indirect participation (or loan participation). In the first way, the leading bank organizes all participated banks to sign a contract of loans with the borrower, providing with loans for the borrower according to same items regulated in one contract. Participated banks and the borrower have a direct debtor-creditor relationship. In the second way, the leading bank supplies or promises to supply loans for the borrower firstly. Then, the leading bank transfers loans supplied or supposed to supply to participated banks. Generally, there is no direct debtor-creditor relationship between participated banks and the borrower.

As a matter of fact, the so-called securitization can be classified into two types. For the first type, capital demanders directly get funds from capital suppliers in financial market by issuing stocks and securities. It is a kind of credit financing. By this way, a borrower can directly obtain funds from investors in market in stead of applying for loans from banks or overdraft. This securitization is also named as "first-order securitization" or "financing securitization". The second type is to separate and reengineer the risks and returns of assets that are lack of liquidity but can generate expectable and stable cash flow by certain structural arrangement, and make these assets available for sale and circulation in market. It is also named as "second-order securitization" or "asset securitization" that derives from the issue of mortgage-backed securities in late 60s in America and then is widely used for other assets. Because it has innovative financing structure and effective carriers and satisfies the constantly changing needs of different borrowers and investors, it becomes the most energetic financial innovative product that develops fast in all countries' capital markets today. The securitization of international syndicated loans is just one corner of asset securitization.

1. The primary mode ------ transferable loan facilities

In the indirectly participated international syndicated loans, the leading bank transfers the loans supplied or supposed to supply to participated banks by certain ways, such as contract novation, credit assignment, sub-loan, and undisclosed agency. The indirect participation is similar to the transfer of loan participation rights and the sale of goods. Therefore, somebody names it as sales of loan. However, as these traditional sales of loans generate certain effects, some problems do exist. For example, loans are usually transferred among commercial banks and it is the loan-remising bank that signs a contract with potential borrowers of loans. Some transfers need complex procedures and even agreements of the borrower. Apparently, these ways belong to primary and oriented trade market scope and the trade costs are relatively higher.

In mid 80s last century, a brand-new way for sales of loans, transferable loan facilities (TLFs), appears in market. In this way, the leading bank uses written certificates stand for the right of taking due principals and interests back. By the issue and circulation of these written certificates, the leading bank can transfer loans. Participated banks can buy these written certificates and sell them freely in market. Apparently, this way broadens the range of transfer. The transfer of syndicated loans will not be limited among the leading bank and participated banks. Besides, the standard written certificates improve the liquidity of transfer, simplifying the boring negotiation and decreasing trade costs. In the practice of syndicated loans, there are three kinds of transferable loan facilities: transferable loan certificates (TLCs), transferable participation certificates (TPCs), and transferable loan instruments (TLIs).

1.1 Transferable loan certificates (TLCs)

Transferable loan certificates are based on contract novation. As we know, in contract novation, if the leading bank or participated banks want to transfer their rights and obligations regulated in the loan contract, they must gain agreements of the borrower and other participated banks. Apparently, it increases trade costs and may not gain their agreements. Therefore, in order to improve the liquidity of loans and reduce trade costs, in practice all participators in syndicated loans will pre-agree with future contract novation in the loan contract. Then the agent bank issues a file that stands for interests of the borrower and all participated banks. This file includes an offer issued by the borrower, the agent bank, and other participated banks for any potential transferee of loans. The transferee of loans will be accepted by all participators as a participated bank in syndicated loans, replacing the former bank that sales loans. By this way, this file becomes a transferable loan certificate. It appended to the back of a loan contract. In the legal aspect, it is an agreement that makes future contract novation work. In general, the agent bank will issue and give some TLCs to every participated bank according to the loan contract. If the loans are amortization, TLCs consist of relevant TLCs to every payment date. The TLCs carry specific principals and interests for certain date. If the transferee accepts the offer in TLCs, the transferee can fill out the form and give them to the agent bank and pay certain register fee. After registering the transferee's name, the agent bank will cancel the former TLCs and inform the borrower about the transfer. Then, the agent bank will issue new TLCs that have same contents with the former, which can help the transferee transfer it again. By this way, syndicated loans can be transferred and circulated freely as securities.

1.2 Transferable participation certificates (TPCs)

In fact, the transferable participation certificates are a kind of transferable loan certificates. Similarly, it adopts the contract novation method to transfer the rights and obligations of participated banks. And it has similar procedures with transferable loan certificates. The difference is that TPCs are right for participating international syndicated loans indirectly by sub-loans. In this way, participated banks can ask the leading bank to sign transferable participation certificates that includes offers for appropriate institutions (usually banks), allowing these institutions to fill out the TPCs and give them to the leading bank, realizing the novation of the sub-loan agreement. In other words, after the endorser (namely the participated bank) signs the TPCs with the transferee and gives the TPCs to the leading bank, the transferee replaces the endorser and becomes a new participator of the sub-loan agreement (namely the loaner). In practice, the sub-loan agreement that includes transferable participation certificates is also named as "transferable participation agreement". The items that allow to issue transferable participation certificates, and guarantee the validity of syndicated loans in this agreement are the same with relevant items in syndicated loan agreement that can issue transferable loan certificates.

1.3 Transferable loan instruments (TLIs)

Transferable loan certificates have two shortcomings. Firstly, if the country where the borrower lives implements foreign exchange control, even though the borrower has permission of getting foreign loans, this permission may become invalid due to contract novation, because after that the borrower will trade with other participators but not former authorized one. Secondly, if the borrower provides with relevant guarantee for syndicated loans, the contract novation may make related warrantors escape from guarantee liability. That is because the new contract between the borrower and the transferee replaces the old one and the former guarantee contract is subject to the old one. According to the law of contract, an invalid principal contract causes invalidation of accessory contract unless the borrower provides with independent guarantee, such as demand guarantee or standby letter of credit.

In order to overcome the two shortcomings, a new loan securitization way, namely transferable loan instruments, appears in practice of international syndicated loans. In essence, transferable loan instruments are a kind of liability warrants or securities. It regulates that the borrower who signs the instrument undertakes certain liability to the "registered holder". As any "registered holder" submits the instrument, the borrower should pay a sum of money on the day predetermined in the instrument unconditionally. In fact, the sum of money regulated in the instrument stands for the due loan paid by the borrower to certain participated bank according to the syndicated loan contract. By transferable loan instruments, participated banks can transfer their loans to transferees by transferring instruments without contract novation. Noticeably, transferable loan instruments are independent and not append to the loan contracts. Participated banks especially ask the borrower sign the instrument according to the loan contract, what is different from transferable loan certificates that are signed by the authorized agent bank and issued for every participated bank. After signing the instrument, the borrower should appoint a registrar to prove its authenticity. Then the instrument becomes validity. Besides, once a transferable loan instrument is signed, the repayment obligation of the borrower will be regulated by it instead of the former syndicated loan contract, what also proves that transferable loan instruments are independent from syndicated loan contracts.

What's more, what the transferable loan instruments transfer are only the rights of taking back principals and interests but not obligations of supplying loans. Therefore it is actually a kind of development and conversion of international syndicated loans' indirect participation, credit assignment. Because contract novation is not necessary for transferable loan instruments, the two shortcomings of transferable loan certificates are conquered. However, because what transferable loan instruments transfer are merely credits, they are right for conditions in which loaners have already supplied all loans.

According to analyses above, we notice that although transferable loan facilities improve the liquidity of banks' assets in a sense and detract risks, they actually follow the way of indirect participation and mechanically apply some operational procedures, such as contract novation and credit assignment. They just become more flexible in form and more skillful in design. To be strict, these ways do not completely break away from indirect participation. In addition, because this securitization mode has complex structure, investors who do not familiarize with credit analysis can not evaluate and know the assets' quality, credit grades, and rational prices. Then, the transfer of those written files mentioned above is limited to large and medium commercial banks. Therefore, in my opinion, transferable loan facilities are only a primary novation and development of sales of syndicated loans. They are the primary mode of securitization of international syndicated loans in a sense.

2. The advanced mode ------ SPV mode

In this securitization mode, the syndicated loans' primary providers, banks, organize and collect their certain assets that are lack of liquidity but have expectable and stable cash flow, and form a "loan pool". Then, these banks can acquire interests by selling the loan pool to a "special purpose vehicle" (SPV). The SPV issues securities by taking the loan pool's expectable cash return flow as warranty. Meanwhile, by means of ranking and promoting credits, SPV enhances the credits of securities in order to attract more investors. The loan pool's cash return flow is firstly used for paying the principals and interests of securities held by investors. Because SPV is the core of the whole securitization trade and also the character of new syndicated loans, therefore, this kind of securitization is named as "SPV mode". In fact, it is the chief mode of assets securitization.

In specific, SPV mode mainly has these operational procedures as follow.

2.1 Establish securitization objectives and form loan pool.

Firstly initiators (syndicated loans' primary providers, banks) clear, evaluate, and audit their syndicated loans that can generate expectable and stable cash flow based on the rates of interests, time limits, and types, and reengineer a homogeneous loan pool. Meanwhile, evaluate the potential loses of bad debts and deduct the costs of securitization, establish the expected objectives of securitization, and ensure that the loan pool's expected cash return flow is more than the assets-backed security's (ABS) expected principals and interests.

2.2 Form SPV, transfer loan assets, and realize a "real sale".

SPV is an important and irreplaceable carrier for syndicated loans' securitization and also the character of this mode. SPV is an independent entity in a legal sense, aiming at operating assets securitization, which can be formed by initiators or the third party. Usually we set limits as follow for SPV operation: If it can not produce any new asset or liability except securitization business, it can not distribute any dividends before paying investors principals and interests. After forming SPV, initiators can sell the loan pool to SPV by signing trade contract with SPV. In order to guarantee a "real sale", the contract should make it clear that as initiators go bankrupt their assets listed in the loan pool should not be included in bankruptcy property, realizing the bankruptcy remote. It means a separation between the loan pool's quality and the initiators' credits, which can help investors to escape from loss of interests due to the bankruptcy of initiators. In judging whether it is a real sale or not, we should think about whether initiators' activities are allowed by the law of bankruptcy in the country. If the sales of assets are illegal, it is not a real sale.

2.3 Design and perfect securitization trade structure and perform assets internal appraisal

After obtaining loan assets, SPV should: Sign a loan assets management contract with initiators or assets management agencies appointed by initiators; Select a trust institution and sign a loan assets trust contract together with initiators; Negotiate and design the assets security structure together with initiators and relevant consultants; Sign underwriting contracts with securities dealers. By signing a series of contracts, the trade structure will be perfect. Then, SPV will invite a credit rating agency to make "internal appraisal" of the trade structure and the designed assets-backed securities. By examining the validity of contracts and files, the credit rating agency completes an internal appraisal of trade structure and assets-backed securities. Based on the appraisal, SPV determines the credit enhancement range necessary for issuing assets-backed securities.

2.4 Improve assets credits and adopt relevant assistant arrangements

Because the cash flow of loan assets does not realize a complete reengineering, the internal appraisal is not quite ideal. In order to attract investors as much as possible, SPV will adopt some credit enhancement methods, including internal credit enhancement and external credit enhancement, to improve the assets-backed securities' credit rate. Internal credit enhancement methods include: (1) bankruptcy remote; (2) issue prior securities and junior securities. Only when prior security holders get principals and interests, can junior security holders obtain their principals and interests. But junior security has higher interests than prior security, which makes junior security attractive. For external credit enhancement methods, the third party usually provides with warranty. In other words, take banks' letters of credit and insurance companies' insurance policies as warranty for assets-backed securities. Once SPV breaks the contract, banks or insurance companies will pay principals and interests of securities off. Besides, the securitization of syndicated loans can not be completed at once. Therefore, considering risks in its operation, such as shortage of cash flow, currency, and rate of interests, SPV must sign warranty investment contract, liquidity facilities contract, financial swaps and foreign exchange trade contract with relevant parties. By these assistant arrangements for loan risks management, SPV can decentralize loan operating risks and realize maximum returns and minimum risks.

2.5 Prepare for securities issue rating and arrange the issue and sale of securities'

After credit enhancement, SPV will invite some well-known rating agencies to make formal issue rating for assets-backed securities. Then, SPV declares the results of rating, prepares legal files for securities issue, and deals with necessary legal procedures. Finally, SPV sign underwriting contracts with securities dealers who sell securities to investors. After SPV gets return from securities issue, it pays initiators funds for loan assets.

2.6 Manage securitized assets and pay off principals and interests of securities at term

It is the initiators or loan assets management agencies appointed by initiators who are in charge of management of loan pool. They are responsible for taking in and recording the loan pool's cash return and saving them in trust institutions' special accounts for accounts receivable. Trust institutions establish accumulation funds (used for paying principals and interests of securities) according contracts and hand in the funds to SPV. After getting accumulation funds, SPV should firstly use the funds for repaying off investors instead of distributing dividends or bankruptcy. Besides, SPV should pay for services during the securitization trade syndicated loans.

Comparing with the SPV mode, transferable loan facilities do not change original loans' legal form and property. Transferable loan facilities help to transfer loan assets to transferees without updating original loan contracts. They are limited to the legal framework of original loans. So they can not decentralize risks effectively. In contrast, SPV, the new securitization mode, operates in a new legal framework that takes securities issue and relevant warranties as main contents. It transfers original loans from loan market (credit market) to capital market. By this way, it can solve the capital liquidity issue of banks. What's more, commercial banks will not be the center of risks. Investors who prefer to winning returns from risks become the real carriers of risks. Besides, along with the development of direct financing that takes market as the medium, the indirect financing business that takes banks and other financial institutions as medium suffers from great impacts. Disintermediation and financial disintermediation appear. The SPV mode serves as an effective financing channel for borrowers and investors, simplifying traditional financial medium, offering different financial tools with different terms and denominations for investors, being an effective way for communication between traditional direct financing and indirect financing. Therefore, comparing with transferable loan facilities, the SPV mode is more appropriate for market, what makes it develop better and faster.

3. Reasons for securitization of international syndicated loans

W. Silber in his theory of financial innovation's constraints points out: financial product innovation is an organization's (banks or enterprises) response to suffered constraints. Main constraints include laws, risks, and competitions. Securitization of international syndicated loans is a kind of assets management innovation emerged in the reforming tide of financial industry. It comes into being in conflicts between financial activities and financial environment. Therefore, we can use theory of constraints to analyze its emergence.

3.1 Shun external pressures from banking supervision

The rise of international syndicated loans' securitization is chiefly caused by the stricter banking supervision standards. The most typical representative is the International Convergence of Capital Measurement and Capital Standards (Basel Capital Accord for short) issued by the Basel Committee in 1988. The core content of Basel Capital Accord is to regulate that to late 1992, the capital adequacy ratio of every bank engaged in international financial business must reach 8%. This accord requires all commercial banks to decrease the proportion of risk assets in the balance sheet in case of commercial banks bearing greater commercial banks. Under the influences of Basel Capital Accord, China, America, Japan, EU, and other countries or regions take actions to improve supervision standards. Under the rule that emphasizes on banks' capital adequacy rate, if a commercial bank has higher risk weight in its balance sheet, it has to hand in more reserves than commercial banks that have lower risks weights to avoid financial risks. It means more operational costs and less return. Therefore, banks that possess high-risk-weight loan assets can transfer their syndicated loans to banks or other investors that have low-risk-weight loan assets by transferable loan facilities or SPV mode, realizing decentralization of loan risks and regulation of law. These securitization modes offer an effective way for participated banks syndicated loans adjusting assets structures, enhancing capital strengths, realizing more flexible management of balance sheets. Meanwhile, because these modes can help to release capital adequacy pressures and improve financial system's safety, they are widely accepted by all participated banks.

3.2 Inner requirement for decentralizing operational risks

Securitization is the inner requirement for participated banks undertaking operational risks respectively and improving assets liquidity. As financial institutions, banks' operational principles are safety, liquidity, and profitability. Thereof, the safety is the most essential. In participating syndicated loans, banks usually face sorts of risks in credits, rates of interests, exchange rates, and inflation. The securitization of international syndicated loans offers a way for decentralizing these risks and carrying out the principle of safety in banks' operation.

In the mode of transferable loan facilities, participated banks transfer all or part of loans, as well as most risks, to other banks or institutional investors, releasing pressures caused by large and long-term syndicated loans. Especially, the leading bank usually undertakes greater credit risks for special borrowers, such as specific countries, currencies, or industries. By sales of loans, the leading bank can decentralize risks. Meanwhile, it is in accord with most countries' legal supervision requirements for forbidding loans to focus on certain country, currency, or industry.

In the SPV mode, the decentralization and transfer of participated banks' loan risks are better. This mode can convert relatively non-current assets into tradable securities in market, turning syndicated loans' potential risks in credits, rates of interests, inflation, and policies, into investors' market risks, decentralizing different risks to all investors in time by the secondary market. Besides, the SPV mode broadens the range of investors, what improves the liquidity of participated banks' loan assets, increasing new financial sources.

3.3 The ultimate engine: improve rate of profits and competitiveness

To win in the furious market competition and gain profits as much as possible are the greatest wishes of all participated banks of syndicated loans. In fact, considering the external pressures from avoiding banking supervision and the inner requirements for decentralizing operational risks, to improve rate of profits and competitiveness is the ultimate engine for securitization of international syndicated loans.

Profits-assets ratio is the standard that evaluates the profitability of a bank. If the leading bank sells syndicated loans by securitization, it can deduct the loan assets from its balance sheet. Meanwhile, the leading bank retains rights of getting parts of interests and charging for commissions. Under some circumstances, it even gains some interests margins. All these factors benefit the improvement of bank's profitability. Besides, just as what has discussed above, securitization enhances the liquidity of syndicated loans. Participated banks can take back some capitals before loans are terminated, and use them for other businesses. By expediting the circulation of credit capitals, operational scale of bank assets is larger and the rate of return on assets is improved, what will inevitably benefit the rise of bank's rate of profits. Moreover, as the realization of sales income, securitization of syndicated loans is free from handing in reserves. It effectively reduces costs of financing.

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