



# A Study on Problems and Issues in Structured Finance

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**Abstract:** *This research article evaluates the major features of structured finance instruments in India. It is argued that structured finance ratings, though useful, have intrinsic limitations in fully measuring the risk of these products, even as their complexity creates incentives to rely more heavily on ratings than for other rated securities. Investors and public authorities need to consider this in their review of structured finance instruments and their markets. This research article aims to explore the use and role of securitisation as main structured finance tool, and to evaluate the legal drawbacks, if any, that underlie the arrangement of this financing techniques. This is done firstly by looking at the legal development of securitisation and at the regulatory incentives that have more recently shaped the originate and distribute mode.*

**Keywords:** *Finance, Instruments, Techniques, Securitisation.*

## I. INTRODUCTION

With the increased complexity of financial products, the diversity of financial institutions, as well as the growing interdependence of financial markets, sources of systemic vulnerabilities are likely to be found in areas of financial innovation, where market forces and participants are left to their own devices and when incentive structures encourage greater risk taking in caring economic environment but need more unfavorable economic consequences when stress occurs. The development of the structured finance market, which has benefited from the attractive proposition of greater risk diversification.

The concentrate of structured finance activities is the pooling of economic assets like loans, bonds, mortgages and consequently issuance of a prioritized capital structure of claims, known as tranches, against these collateral pools. Because of the prioritization scheme used in structuring finance, many of the manufactured tranches are safer than the average asset in the underlying pool. This ability of structured finance to repackage risks and create “safe” assets from otherwise risky collateral led to a dramatic expansion in the issuance of structured securities, most of which were viewed by investors to be virtually risk-free and certified as such by the rating agencies. Structured finance is a broad term used to describe a sector of finance that was created to help transfer risk using complex legal and corporate entities. This transfer of risk, as applied to the securitization of various financial assets (mortgages, credit card receivables, auto loans, etc.), has helped provide increased liquidity or funding sources to markets like housing and to transfer risk to buyers of structured products; it also permits financial institutions to remove certain assets from their balance sheets as well as provides a means for investors to gain access to diversified asset classes.

## II. CONCEPT OF STRUCTURED FINANCE

Structured finance includes all advanced private and public financial arrangements that serve to efficiently refinance and hedge any profitable economic activity beyond the scope of conventional forms of on-balance sheet securities (debt, bonds, equity) at lower capital cost and agency costs from market impediments on liquidity. In particular, most structured investments combine traditional asset classes with contingent claims, such as risk transfer derivatives and/or derivative claims on commodities, currencies or receivables from other reference assets, or Replicate traditional asset classes by new financial instruments. Structured finance is raised through financial and non-financial institutions in both banking and capital markets if established forms of external finance are either unavailable for a particular financing need, or traditional sources of funds are more expensive for what would otherwise be an unattractive investment based on the issuer’s desired cost of capital.

Structured finance offers issuers huge flexibility to create securities with diverse risk-return profiles in terms of maturity structure, security design, and asset type, providing increased return at a customized degree of diversification proportionate to an individual investor’s desire for risk. Therefore, structured finance contributes to a more complete capital market by offering any mean-variance trade-off along the efficient frontier of optimal diversification at lower transaction cost. However, the increasing complications of the structured finance market, and the ever growing range of products being made available to investors, consistently create confront in terms of efficient assembly, management and distribution of information.

Investors in securitization have a greater choice of best quality investments at their disposal, whose market valuation produces greater overall efficiency and liquidity of capital markets. The tradability of securitized asset risk also assists the synthetic assembly and dynamic adjustment of asset portfolios through secondary markets according to investor preferences. As opposed to ordinary debt, a securitized contingent claim on a assured portfolio performance affords investors to quickly adjust their investment holdings at low transaction costs in response to changes in personal risk sensitivity, market sentiment and consumption preferences.



### III. OBJECTIVES OF THE STUDY

The major objectives of this research paper are as under:

1. To understand structure finance and conventional finance
2. To analyse challenges and issues of structured finance
3. To study the problems of Structured Finance
4. To study the risk and return of structured finance

### IV. THE RISKS OF STRUCTURED FINANCE

Ratings, as pointers of the default risk surrounded in debt instruments, are based on expected loss or probabilities of default. The estimation of expected loss or profitability of default for a structured finance tranche will significantly rely on the size i.e. thickness and position of that tranche in the loss distribution of the underlying asset pool. To obtain this evaluation, as shown above, an estimate of the asset pool's loss distribution (the result of credit risk modelling) has to be united with information about the structural specifics of the deal and its tranches (the result of structural analysis). The major factors driving the loss distribution of any portfolio and, hence, the three main inputs into each agency's structured finance rating methodology are estimates of probabilities of default of the individual obligors in the pool; recovery rates; and default (time) correlations among the obligors within the pool. The choice of the approach used in combination with these inputs to model losses will depend on collateral pool specifics, such as the number and homogeneity of assets, obligor classes, and historical performance.

### V. RATINGS AND THE RISK PROPERTIES OF STRUCTURED FINANCE PRODUCTS

Ratings are evaluations of expected loss or probability of default and thus replicate an actuarial view of credit risk that depends only on the first moment of the distribution of possible outcomes. Holding expected loss stable, however, an investment will tend to be riskier if its loss distribution is more dispersed. Risk profiles of financial instruments are, hence, more fully described when estimates of expected loss or profitability of defaults are combined with information on the ex bet uncertainty of losses as reflected, for example, in the variance and higher moments of the loss distribution. Ex ante credit Loss uncertainty, in turn, has come to be commonly referred to as unexpected loss. With regard to structured finance, two considerations benefits are:

- ❖ Risk assessment among structured finance tranches because of the additivity of expected loss, the process of tranching will distribute the expected loss of the underlying portfolio across the several types of securities issued against the pool. The equity tranche, although normally the smallest tranche in terms of estimated size, will end up bearing much of the pool's expected loss. In contrast, the senior tranche, being highly rated, will bear only a small portion of the expected loss, in spite of laying claim to most of the structure's principal. Tranche unexpected loss will show similar patterns across tranches: measured against tranche notionals, the unexpected loss of a tranche will tend to be higher for more junior tranches. The risk profile of a structured finance tranche, in fact, depends largely on two factors: its seniority (as determined by the lower boundary of the tranche) and its thickness i.e. the distance between the upper and lower tranche boundaries. The lower the seniority, the lower the level of loss protection and the higher the risk of a given tranche. The narrower the tranche, the more the loss distribution will tend to vary from the distribution for the whole portfolio in that it is likely to be more bimodal and, thus, riskier.
- ❖ Risk assessments with rated assets is another facet of structured finance is that tranching can lead to risk profiles that are significantly diverse from those of ordinary bond portfolios with the same rating. One factor behind this examination is the possibility of zero tranche recoveries for subordinated tranches. As a result, if defaults are rigorous enough, investors in all but the most senior tranches may lose the entire value of their investment even in the case of non-zero recoveries. The narrower the tranche, the riskier it will be, as it takes fewer defaults for the tranche to be wiped out once its lower loss boundary has been breached. Subordinated tranches, hence, have a wider distribution of outcomes than like-rated bond portfolios and will thus need to pay a higher spread than traditional debt instruments to compensate for the added risk.

### VI. STRUCTURED FINANCE AND CONVENTIONAL FINANCE

The flexible nature of structured finance overlaps the vague boundary between traditional fixed income products, debentures and equity on one hand and derivative transactions on the other hand. Notwithstanding the apparent difficulties of defining structured finance, a functional and substantive differentiation seems to be most instructive for guiding an informed demarcation between the most salient properties of structured and conventional forms of external finance.



## VII. PROBLEMS AND ISSUES IN STRUCTURED FINANCE

Pooling and tranching, while being key sources of value in structured finance, are also the main factors behind what might be called the problems of these instruments. To the extent that pooling is concerned, assessment of risk and return of a structured finance security imposes modelling the loss distribution of the underlying asset pool, which may be complex when the pool consists of a small number of diverse assets. Tranching adds an extra layer of analytical complexity, the evaluation of a structured finance instrument (in other words, a tranche) cannot be confined to analysing asset pool loss. It is also essential to model the distribution of cash flows from the asset pool to the tranches; that is, to appraise the deal's specific structural features. The allocation of principal and interest payments received from the collateral pool and for the redirection of these cash flows in the case of stress situations, in addition to specifying the rights and duties of various third parties involved in the transaction. Consequently, structured finance instruments give rise to "non-default" risks i.e. risks that are not related to defaults in the collateral pool, but which nevertheless affect the credit risk of issued tranches. By inference, to the extent that equity investors can influence initial portfolio selection, they may be willing to sacrifice credit quality in exchange for enhanced yield payments, i.e. by including credits with wide spreads for given rating levels.

## VIII. RECCOMENDATIONS AND SUGGESTIONS

- ❖ The distinction of the several methods of credit risk transfer through credit derivatives in a wider and narrower sense in addition to securitization transactions illustrates the need for more complete and judicious regulatory considerations.
- ❖ During the credit crunch from late 2007 and into 2008, the buyers of highly rated structured finance products largely stopped buying. The early cause for this change was that subprime related securities were experiencing large losses, which created apprehension about structured finance products more generally.
- ❖ Beginning in late 2007 and continuing well into 2008, it became increasingly clear to investors in highly-rated structured products that each of these three major assumptions were thoroughly biased against them.
- ❖ A good understanding of all these issues is serving on market participants as well as country officials charged with safeguarding financial stability and the sound operation of derivative markets. Given the increasing complexity of financial products, the diversity of financial institutions, as well as the growing interdependence of financial markets, the sound regulatory oversight of this important segment of capital markets will depend on the convenient and good resolution of challenges arising from consistent credit risk management, risk mutualisation, and prudential standards that guarantee market stability in crisis situations.
- ❖ Investors need to recognize the fundamental difference between singlename and structured securities, when it comes to exposure to systematic risk. Unlike traditional corporate bonds, whose fortunes are primarily driven by firm-specific considerations, the performance of securities created by tranching large asset pools is stoutly affected by the performance of the economy as a whole.
- ❖ While structured finance instruments can contribute to market completion and a better scattering of credit risk, they also give rise to a number of questions with potential financial stability allegations.

## IX. CONCLUSION

The quick development of structured finance markets entails that new structures and asset classes are constantly being introduced. As a result, different structures create new opportunities for unexpected behaviour by note holders or third parties, while the scarcity of data on the historical performance of new asset classes generates additional model risk. Given the issues reflected in this research paper and the fact that the structured finance market remains largely unproven, policymakers and market participants alike have an interest in the developments in these markets and in attempting to understand the core challenges faced. "A key goal of the tranching process is to create at least one class of securities whose rating is higher than the average rating of the underlying collateral pool or to create rated securities from a pool of unrated assets. This is accomplished through the use of credit support (enhancement), such as prioritization of payments to the different tranches."

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