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Commentary

Working of securitization and its benefits

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DESCRIPTION

Marketable financial instrument is designs by procedure where an issuer. By pooling or merging various financial resources into one group. Securitization offers opportunities for frees up capital and investors for inventor, both investors and frees up capital promotes liquidity in the marketplace. In any financial asset can be securitized by, fungible item of monetary value and turned into a tradable. As securitization is mostly occurs with loans and other assets that generate receivables. And commercial debtor consumer. It involves the credit card debt obligations and pooling of contractual debts where as auto loans. The company holding the assets is known as the originator in securitization.it would like to remove from its associated balance sheets by gathers the data on the assets.

For example: A bank consists of wide variety of mortgages and personal loans in which they don't want to service anymore. For a specified rate of return the Investors will buy the created securities. That gathered group of assets is considered a reference portfolio.

Issuer who will create tradable securities then the originator then sells the portfolio. In the assets in the portfolio securities represents are created in stake. Securitized financial instrument is called tranches, which is divided into different sections. In various factors tranches consist of individual assets are grouped such as the type of loans the amount of remaining principal and their maturity date, their interest rates.

Different degrees of risk and offer different yields are carries by tranche. The higher the potential rate of return. The borrowers who are less-qualified are charged with underlying loans, higher interest rates are caused due higher levels of risk correlate. Securitization has a perfect example which is Mortgage-Backed Security (MBS). The combined mortgages formed into one large portfolio, Based on the mortgage's inherent risk the default the issuer can divide the pool into smaller pieces. Each packaged as a type of bond with smaller portions are sold to investors. Investors effectively take the position of the lender, by buying into the security. The associated assets from its balance sheets are removed by original lender or creditor.by the allowances of securitization. They can underwrite additional loans with less liability on their balance sheets. On the underlying loans the Interest payments are being made and debtors or borrowers are with obligations. They earn a rate of return based on the associated principal because the investors get a profit.

BENEFITS OF SECURITIZATION

Letting retail investor's purchase shares in instruments that would normally be unavailable to them as a process of securitization creates liquidity. Many loan-based securities are backed by tangible goods, unlike some other investment vehicles. Debtor should cease the loan repayments on his house or his car; it can be liquidated and seized to compensate those holding an interest in the debt. The amount of liability held on their balance sheet is reduced, the originator moves debt into the securitized portfolio with reduced liability; and then they are able to underwrite additional loans.

For example: A portions of mortgages are brought by an investor, with an MBS and they receive regular period of returns as principal payments and interest. Securitization of mortgages is necessary, because small investors couldn't afford to buy mortgages of large pool.

Pros

- Turns illiquid assets into liquid ones
- Frees up capital for the originator
- Provides income for investors
- Let's small investor play

Cons

- Investor assumes creditor role
- Risk of default on underlying loans
- Lack of transparency regarding assets
- Early repayment damages investor's returns

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