**Scientific Bulletin of
Politehnica University of Timisoara, Romania**

Transactions on ENGINEERING AND MANAGEMENT

Vol. 1, Issue 1, 2015

Considerations on Securitization of Bank Assets

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Abstract - In this paper we aim to highlight the importance of understanding securitization of banking assets. The economic and financial crisis demonstrated the importance of regulation in the banking sector, regulations which can lead to a better management of risks, balance between loans and deposits and many more. The securitization of banking assets represents a financial innovation which has a long history in the capital markets.

Keywords: assets, securitization, regulation, liquidity, cash flow

I. INTRODUCTION

Securing assets involves changing the traditional balance sheet assets traded in the market, such as a loan, in marketable securities and move them off balance. When the assets of a bank are secured, the different functions of traditional bank lending are separated [1, 2, 5].

We could define securitization as the conversion of receivables and cash flow generated from a portfolio of financial assets such as mortgage loans, auto loans, credit card receivables and others into the marketable securities [3].

"The crisis or so call Panic of 2007-2008 was a run on the sale and repurchase market (the "repo" market), which is a very large, short-term market that provides financing for a wide range of securitization activities and financial institutions" [4].

II. SECURITIZATION OF BANKING ASSETS

Disconnecting the involved functions in securitization significantly alter the traditional role of intermediary banks, there are some reasons of attractiveness for the banks of securing assets. In the case of a bank, assets consist of all its placements in loans in securities, bonds, interbank market, capital market, stock market etc., plus buildings, land, equipment and other assets (participations / shares owned in other companies) [6, 7].

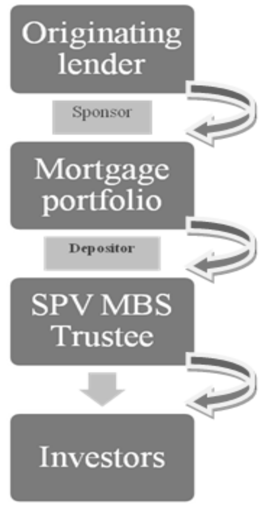

Fig. 1. Assets securitization model (adapted from www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/article01)

Security can improve credit risk management, because if a bank finds that its loans are pre concentrated in an area, it can secure some of them to reduce exposure [6].

Securing can influence the bank cost of funds, this depending on whether any benefits of securing an asset class is adjusted by increasing funding costs higher due to lower quality loans that remain in balance [8]

The securitization of banking assets represents a financial innovation witch has a long history in the capital markets. This process implicates the insurance of securities witch derive cash flow from the underlying assets [8, 9].

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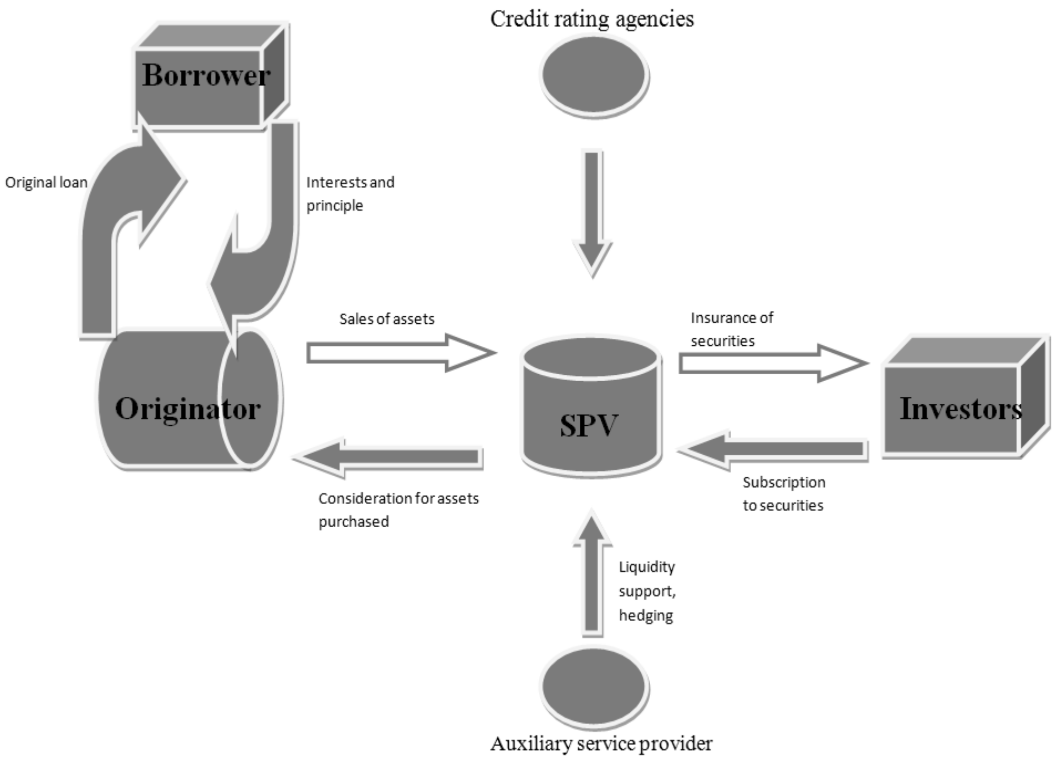

Fig. 2. Banking Asset securitization structure
(adapted from http://www.imf.org/external/pubs/ft/fandd/2001/03/ketkar.htm)

III. BASEL 3 IMPACTS ON ASSET SECURITIZATION

The global voluntary regulatory standard, Basel 3 continues on from Basel 2 which was mainly focused on the level of capital. When lending money, banks engage in activities wearing some level of risks. For this Basel 2 supposes that some risks come with lending and part of the capital must be set aside to cover this risks. The risk is not equal to all of the bank loans and for this reason risks are weighted in order to arrive at the total amount of risk weighted assets [6, 7, 8, 9].

Basel 2 recommends banks to set aside 2.5 per cent of the risk weighted assets. Basel 3 builds up from Basel 2 and imposes not 2.5 per cent but instead 7 per cent or even more, depending on the nature of the activity and the type of bank witch lead to a considerable increase of the required capital for banks.

The second element Basel 3 adds relates to the size of the balance sheet because in the past years we have seen balance sheets of banks increasing significantly [9].

Basel 3 insists and recommends banks to take initiative to limit this process and even to take initiative to reduce the balance sheet size. This process can be done according to Basel by putting a limit on the size of the activity a bank can develop in comparison to its own capital and for this to occur a leverage ratio has been developed.

The third element added by Basel 3 and probably the most important one is liquidity.

In the context in which banking assets in Eastern Europe are still overrated liquidity is a most important aspect for a financial institution or in our case a bank. A bank receives deposits and grants loans and every day a bank disposes of a certain level of cash through its activity of collecting deposits and by providing cash to clients while granting loans. Due to the recession process we are still facing, its likely that the bank will not be in equilibrium at the end of the day. If it has more deposits than loans it will deposit some of them in another bank and if it granted more loans that it received deposits it will go or a loan with another bank by the inter banking market [8, 9].

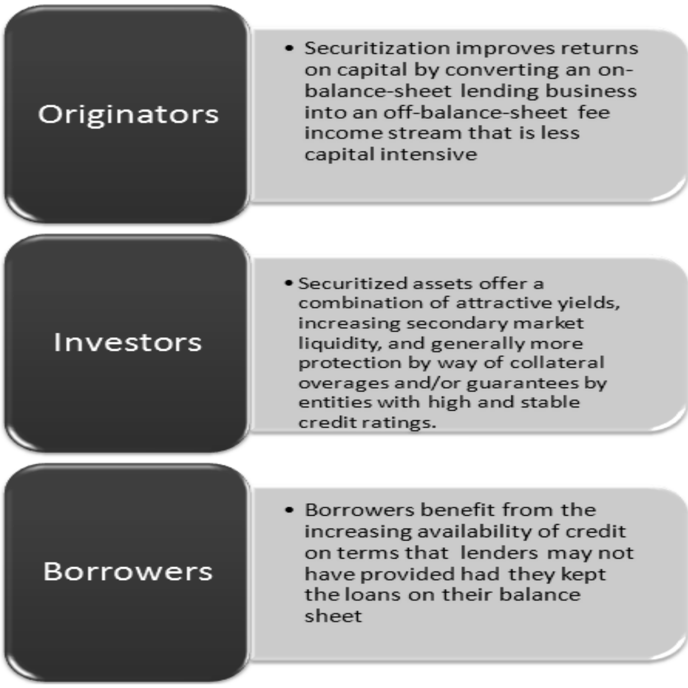

Fig. 3. Benefits of asset securitization

Asset securitization can improve risk management by controlling the in and outgoing cash flow of the bank. This cash flow is typical to each bank (for example savings banks are specialized in the collecting of deposits meanwhile a merchant bank is specialized in lending activities).

The success in the banking industry is the equilibrium between its loans and deposits and the securitization of assets is an important insurance of this equilibrium. To ensure such a equilibrium exists, Basel 3 has developed a specific regulation which consists of standardized stress test on all banks. The banks must have sufficient liquidity for a period of 30 days of stress conditions.

The improvement of risk management trough securitizing assets improves also the management of the level of liquidity of the bank but this will put pressure on the net results of a bank and must be done kipping in mind the inquired increase in the capital for banks.

IV. CONCLUSIONS

Asset securitization represents an important aspect to a commercial bank because of the profitability challenge trough balancing loans and deposits. To manage this equilibrium cross selling is an important aspect to a bank which will lead eventually to operational intimacy which will help banks to retain the required liquidity for the stress test. The importance of securitization of assets in the banking sector is outlined also by the further deterioration in asset quality in Eastern Europe without of a consolidation of capital required by Basel 3 standard. In the last years the quality of assets is on a negative trend in Central and Eastern Europe. Slowing down economic growth, worsening asset quality and potential funding problems may affect the stability of the financial sector.

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