Vivriti Asset Management



Securitisation Primer Series – Issue 3

The Waterfall Mechanism

Separating the gold and the lead

Securitisation is not financial alchemy. It cannot transform poor-quality credit into high-quality credit, nor can it eliminate the underlying risk of a loan pool. The aggregate credit risk of a securitised pool remains unchanged.

What securitisation does exceptionally well, however, is identify and redistribute that risk to suit different investor preferences. Think of it as pulling an alloy back into its constituent metals - the gold and the lead both remain, but each now sits with the investor willing to own it.

This separation is achieved through 'Tranching', where the securitised pool is divided into multiple layers with varying degrees of seniority and subordination (refer to *Securitisation Primer Series – Issue 2* for more).

Once these tranches are created, the 'Waterfall Mechanism' comes into play. It governs how cash flows generated by the underlying loan pool are distributed among investors by setting an order of who gets paid first and how much. In effect, it's a priority-based payment system that allocates both cash flow and credit risk across different investor classes.

For a securitised pool, cash flows and credit losses are typically allocated across three tranches through a predefined priority structure:

Senior Tranche (Lowest Risk, Lowest Return): Receives the highest priority in the distribution of interest and principal repayments from borrowers. It is the last tranche to absorb credit losses and incurs losses only after the subordinate tranches have been fully exhausted.

Mezzanine Tranche (Moderate Risk, Moderate Return): Receives payments only after the Senior Tranche has been paid in full. During default scenarios, it absorbs losses only after the Equity Tranche has been exhausted, providing an intermediate level of risk and return.

Equity (First-Loss) Tranche (Highest Risk, Highest Return): Receives any residual cash flows after the Senior and Mezzanine Tranches have been fully paid. It is the first to absorb losses arising from borrower defaults and continues to do so until its principal is completely exhausted.

Did you know?

Indian Pass-Through Certificates (PTCs) are empirically seen having two slices only - senior and equity.

CASH FLOWS: THE WATERFALL OF PAYMENTS

When cash flows are received from borrowers in the form of interest payments and loan repayments, they are distributed in the following order.



LOSSES: THE WATERFALL OF DEFAULTS

Any defaults (losses) are absorbed in the reverse order-protecting higher trenches first



In securitisation, protection comes at a price. The higher a tranche sits in the waterfall, the safer it is but the lower its yield. The lower it sits, the greater the risk and the higher the yield investors expect.

Hence, in securitisation, risk reduces upwards; returns increase downwards.

Did you know?

A US Asset-Backed Securitisation (ABS) deal is sliced far more finely - a senior tranche, several mezzanine tranches rated down the scale, and a residual equity piece at the bottom. Five or six tranches is routine, not exotic.

Vivriti Asset Management Private Limited | SEBI Registered Portfolio Manager (Co-investment services only) (Regn. No. INP000009913) & AIF Investment Manager

Disclaimer: The information provided in this article is for general informational purposes only and is not an investment, financial, legal or tax advice. While every effort has been made to ensure the accuracy and reliability of the content, the author or publisher does not guarantee the completeness, accuracy, or timeliness of the information. Readers are advised to verify any information before making decisions based on it. The opinions expressed are solely those of the author and do not necessarily reflect the views or opinions of any organization or entity mentioned.