Securitisation

The process simplified

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The Process of Securitisation: simplified

Introduction

The process of Securitisation in India is governed by *The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002* (often referred to as Securitisation Act).

Securitisation Act defines Securitisation as '*acquisition of financial assets by any Securitisation Company or Reconstruction Company (SPV) from any Originator, whether by raising of funds by such company from Qualified Institutional Buyers (QIBs) by issue of security receipts representing undivided interest in such financial assets or otherwise*'.

Securitisation is a process through which illiquid assets are transformed into more liquid form and distributed to a broad range of investors through capital markets. The process involves packaging of individual homogenous loans and distributed among various investors in the form of Coupons or Pass through certificates or Pay through certificates through a SPV.

In other words, Securitisation is the process of conversion of existing assets or future cash flows into marketable securities. In simple words, securitisation deals with the conversion of assets which are not marketable into marketable ones. For the purpose of distinction, the conversion of existing assets into marketable securities is known as asset-backed securitisation and the conversion of future cash flows into marketable securities is known as future-flows securitisation.

In short, securitisation is a concept by which a financial institution can effectively sell off its loan portfolio and thereby free up its capacity for lending.

Objective

A lender has to normally wait for recovery of principal and interest over a period of time. When securitisation is done, he sells his right to receive future payments and receives upfront payment at a discounted value. He can use these funds once again for advancing loans. By this process his long term illiquid assets are converted into current assets.

Some of the assets that can be securitised are loans like car loans, housing loans, ticket sales, credit card receivables, lease finance receivables etc.

Example of securitisation of future receivables: *Suppose Mr X wants to open a multiplex and is in need of funds for the same. To raise funds, Mr X can sell his future cash flows (cash flows arising from sale of movie tickets and food items in the future) in the form of securities to raise money.*

This will benefit investors as they will have a claim over the future cash flows generated from the multiplex. Mr X will also benefit as loan obligations will be met from cash flows generated from the multiplex itself.

Securitisation can be with recourse (i.e. when SPV or investors can recover the defaulted amount of borrower from the Originator) or it can be without recourse (i.e. loss if any is to be borne by the SPV or investors).

Modus Operandi *(as per provisions of Securitisation Act)*

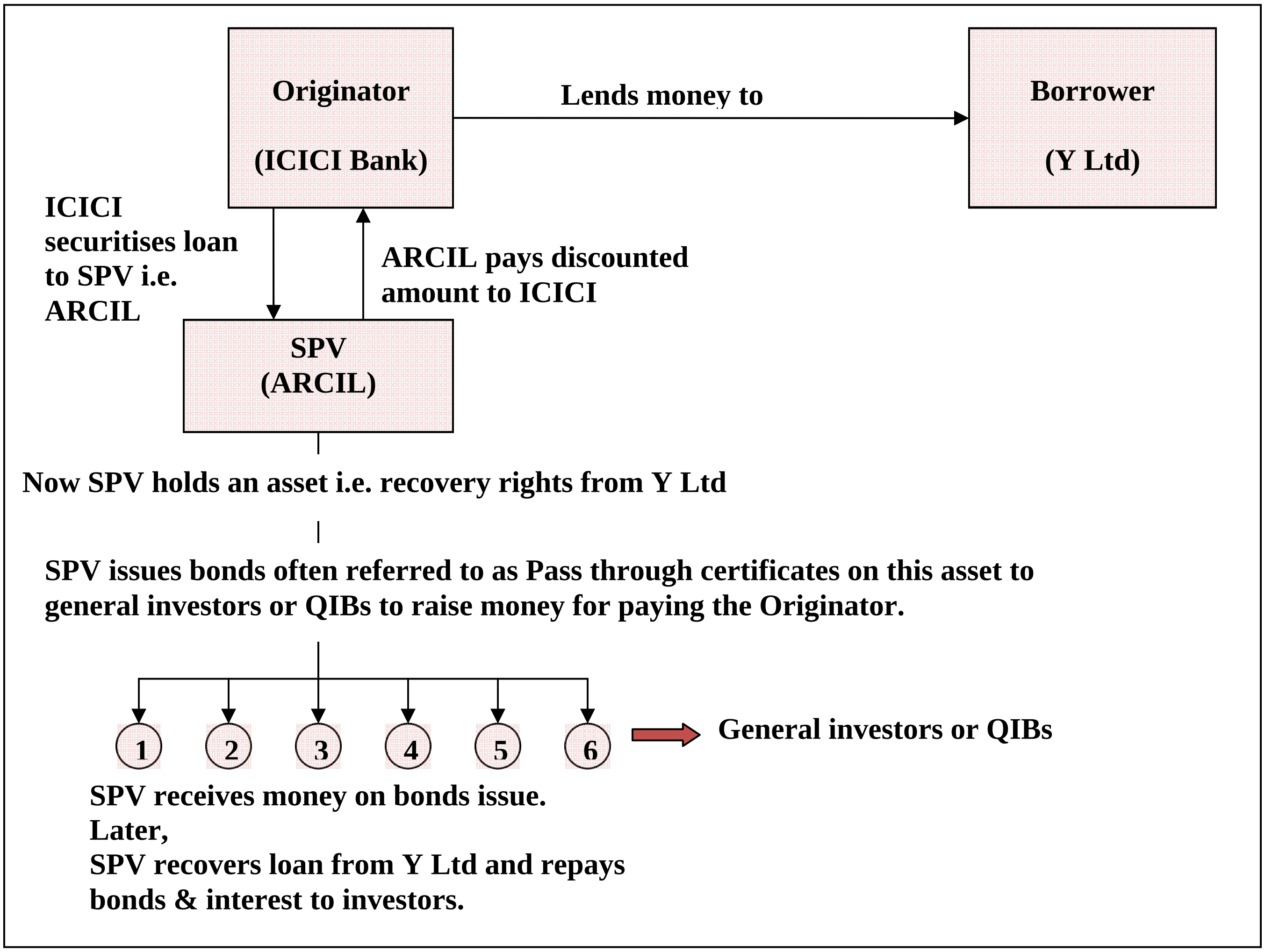
The following steps briefly describe the working of this technique:

1. Originator sells the loan (or other financial asset) to the SPV at a discounted value.
2. SPV raises the money from investors by raising debt instruments which are listed on stock exchanges. (The securities are rated by credit rating agencies like CRISIL etc)
3. Money raised by SPV is given to the Originator.
4. SPV collects from the borrower the principal and interest amount and repays the debt instrument held by investors.

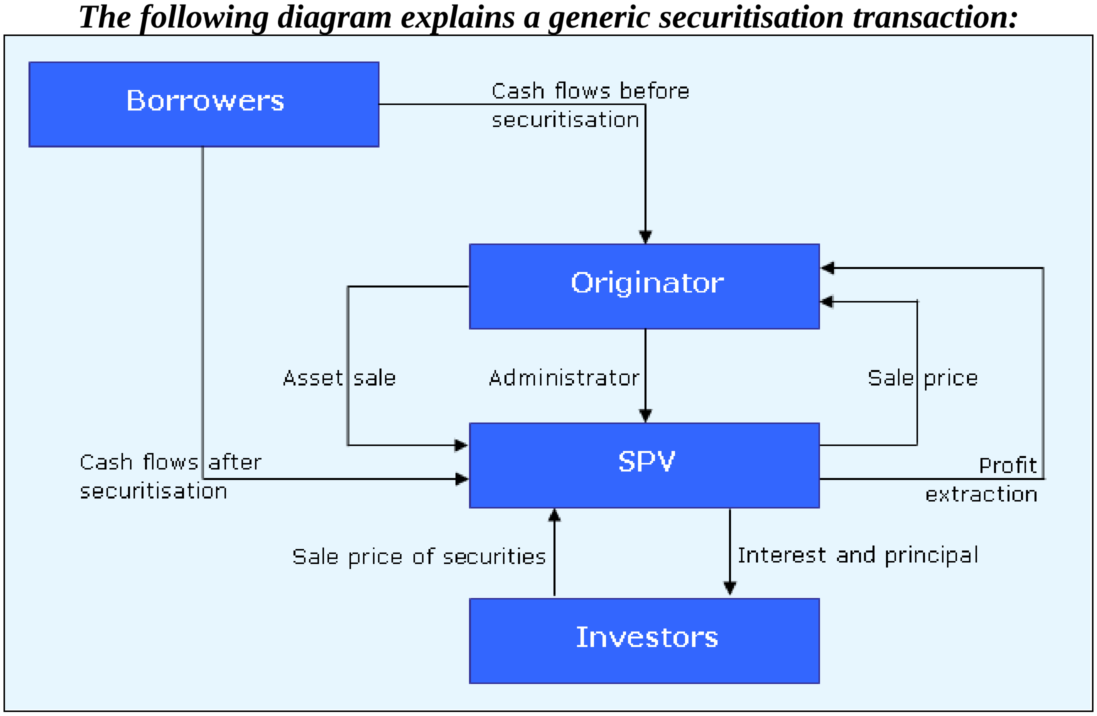
Note: *Securitisation can also be made partially i.e. only principal amount portion or only interest portion or only a part of the loan (say) 75% of the loan amount is securitised.*

Diagram on next page....

The diagram below illustrates the process of Securitisation in India:



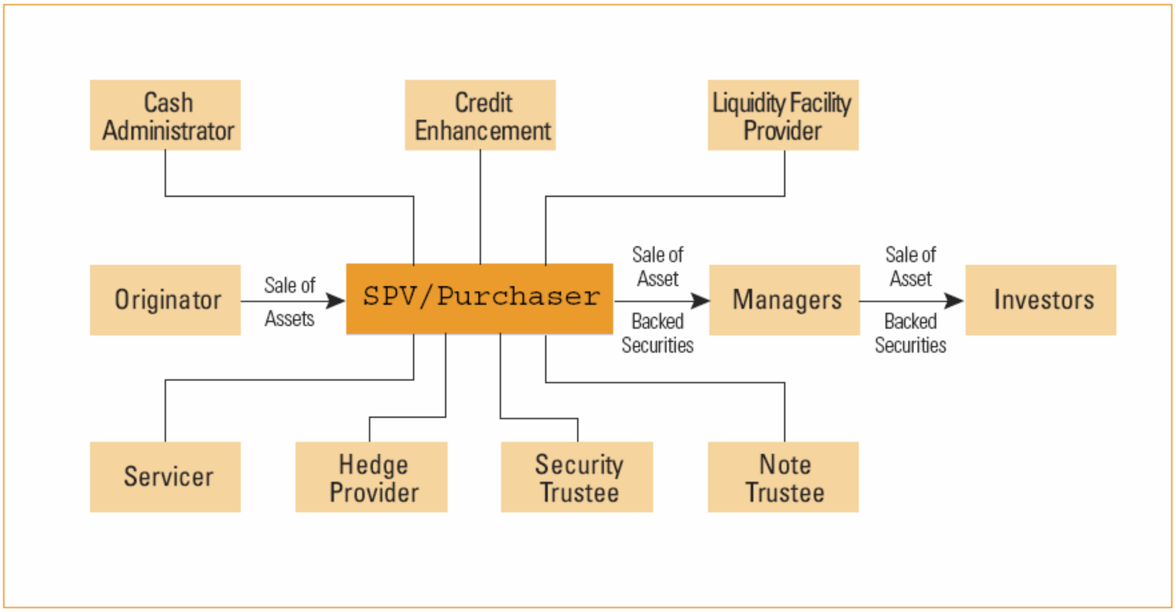
The following diagram explains a generic securitisation transaction:



Types of Securitisation

There are three principal types of securitisation:

1. **True sale:** In a true sale securitisation, a company sells assets to a special purpose vehicle/company (the SPV) which funds the purchase by issuing bonds to the capital markets.

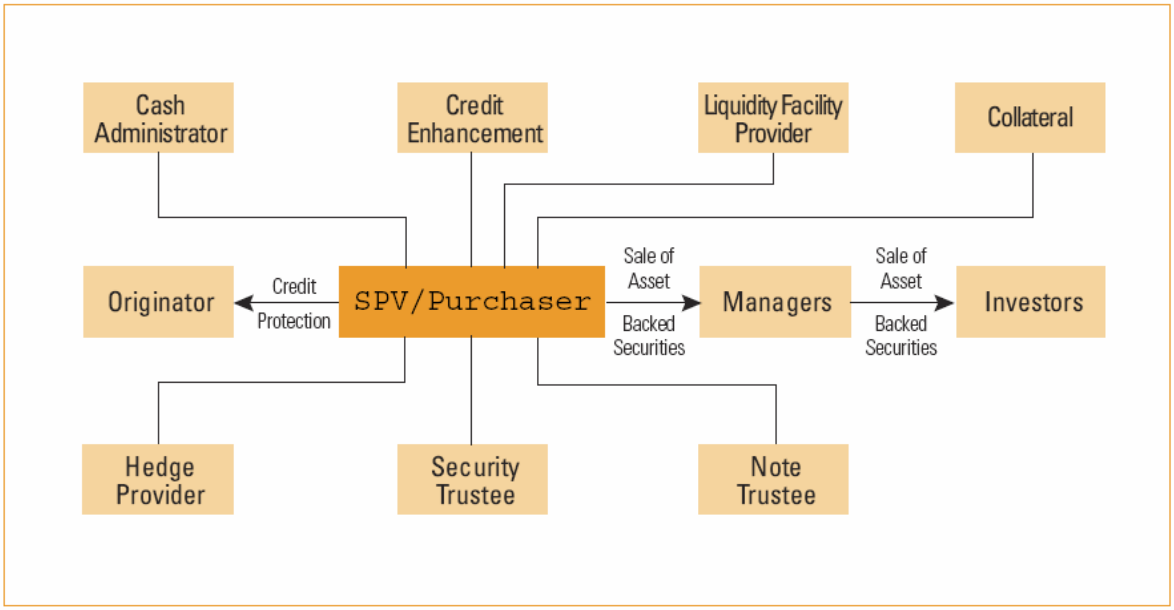


Description of the Structure

The above diagram shows a typical structure for a true sale securitisation. The Originator (for instance a bank selling mortgages) sells certain assets (the Assets) to the SPV/ Purchaser. The Assets will be serviced by the Servicer (often the Originator), for instance with respect to mortgages sold to the SPV, the Originator will continue, on behalf of the SPV, to collect principal and interest from borrowers on such mortgages and will, where appropriate, take enforcement action in respect of such defaulted mortgages. As the SPV has no employees it will appoint a Cash Administrator to make all relevant payments on its behalf and is also likely to appoint a company to provide company secretarial and other administrative functions.

The SPV funds the purchase of those assets by selling asset-backed securities (whose performance is dependent on the performance of the Assets) (the Bonds) to the Managers who will in turn sell those securities to the Investors. Investors will be free to sell the Bonds or retain them.

2. **Synthetic Securitisation:** In a synthetic securitisation, the company does not sell any assets, but transfers the risk of loss associated with certain of its assets to an SPV or a bank against payment by such company of a premium or fee to the SPV.



Description of the Structure

The above diagram shows a typical structure for a synthetic securitisation. As you will note it is very similar to a "true sale" and most of the structural features are the same. The key difference is that the Originator does not sell any assets to the SPV (and therefore, does not obtain any funding or liquidity under the transaction). Instead the Originator will enter into a credit default swap with the SPV in respect of an asset or pool of assets. Under this contract the SPV will pay the Originator an amount equal to any credit losses suffered in respect of such asset or pool of assets (less a minimum threshold amount—similar to an "excess" in insurance). The Originator's exposure to those assets is therefore transferred to the SPV. The Originator in return will pay a fixed amount to the SPV, usually on a quarterly basis.

The SPV will issue Bonds to Investors via the Managers. The SPV's ability to repay principal and pay interest under the Bonds will depend on whether the SPV has to make payments under the credit default swap. The SPV's income streams in a synthetic transaction are the fixed amounts paid by the Originator under the credit default swap and interest amounts received on the collateral.

3. **Whole business securitisation:** It is essentially a secured loan granted by an SPV to the relevant company. To grant the loan, the SPV uses proceeds of bonds issued into the capital markets whereby the company grants security over most of its assets in favour of the bondholders. This Position Paper deals primarily with true sale securitisation.

Types of assets that can be securitised

In principle, any assets representing future (predictable) cash flows can be securitised to the extent that they can be effectively transferred to the SPV through a true sale. In this respect, securitisation of auto loans, credit card receivables, computer leases, unsecured consumer loans, residential and commercial mortgages, franchise/royalty payments, and other receivables relating to telecom, trade, toll road and future export have gained prominence.

Benefits of Securitisation

- ✓ **Benefit to Originator:**
  - Securitisation helps convert illiquid assets into liquid, marketable assets.
  - Securitisation can be used as a strategic tool by corporates.
  - Use of securitisation as an alternative funding tool by corporate
  - Securitisation enables financial institutions free up their capacity for further lending.
  - Securitisation helps improve balance sheet efficiency. This process leads to the financial asset being taken off the balance sheet of the originator, thereby relieving pressures of capital adequacy, and provides immediate liquidity to the originator.

- ✓ **Benefit to investors:** Investor experience of investing in securitised paper has internationally been quite good, for primarily 3 reasons:
  - Securitisation being a structured finance instrument can be more closely aligned to investor needs. Investors can invest in exactly what suits their investment policy the best.
  - Securitisation asset classes have shown much higher rating resilience. Rating transition histories have been published by both Moody's and Standard and Poor's depicting this. Recently, Fitch also came out with a rating transition history of ABS to prove this point.
  - Default history of securitisation transactions is much safer - there have been very few defaults over the past 16 years.
  - Default recovery rate of securitisation transactions has been significantly higher than in case of defaulted corporate bonds.
  - The debt instruments issued by the SPV are generally rated by credit rating agencies like CRISIL hence are much safer.

- ✓ **Benefit to the economy:**

  Securitisation benefits the economy as a whole by bringing financial markets and capital markets together. Financial assets are created in the financial markets, e.g., banks or mortgage financing companies.

Securitisation connects the capital markets and financial markets by converting these financial assets into capital market commodities. The agency and intermediation costs are thereby reduced.

Role of the Rating Agencies

Most asset-backed securities are rated by international rating agencies to enhance their attractiveness to investors and provide a guideline for their pricing. The rating agencies closely examine the legal structure of the transaction, the quality of the securitised asset pool and the ability of the Originator to service the assets. Based on this analysis, the rating of the securities is determined.

Parties to the securitisation process and their roles

The key parties involved in a securitisation and their roles3 are as follows (further parties may be involved depending on the structure of the individual transaction):

- **Originator**—owner and "generator" of the assets to be securitised. Examples of Originators are: banks and other financial institutions, corporates, governments and municipalities.

- **Seller**—seller of the assets to be securitised. In many cases, the Seller and the Originator in a transaction is identical. This is however not necessarily the case. For instance, an entity may purchase assets from its affiliates and then act as central Seller in a securitisation.

- **Purchaser**—a special purpose vehicle (SPV) which purchases the assets to be securitised. The Purchaser funds the purchase price by issuing asset-backed securities into the capital markets (in this capacity, the Purchaser is also referred to as the Issuer).

- **Servicer**—services the assets to be securitised (frequently the Originator retains this role). Where receivables are securitised, the Servicer will collect, administer and, if necessary, enforce the receivables.

- **Back-up Servicer**—will service the assets in the event the Servicer is unable to service them, or in the event the Purchaser exercises its right to remove the Servicer (for instance, as a result of the insolvency of the Servicer).

- **Liquidity Facility Provider**—provides a liquidity facility in relation to certain tranches of the asset-backed securities. Typically, a liquidity facility is provided in conduit transactions where the Purchaser issues revolving short-term commercial paper to fund the purchase of the assets. The Purchaser may draw upon the liquidity facility if it is unable to refinance maturing commercial paper because of a market disruption. The liquidity facility thus secures commercial paper investors against a default in such a case. Liquidity facilities are also sometimes required in standalone securitisations.

- **Investors**—purchasers of the asset-backed securities. Examples of investors in the securitisation market are: pension funds, banks, mutual funds, hedge funds, insurance companies, central banks, international financial institutions and corporates. Lead Manager—arranger and structurer of the transaction (in the context of conduit transactions, also referred to as Programme Administrator). The Lead Manager is often the primary distributor of the asset-backed securities in a particular transaction. Individual distributors are also referred to as Managers.

- **Rating Agencies**—rate the asset-backed securities. The three key rating agencies in securitisation are Standard & Poor's, Moody's and Fitch.

- **Hedge Providers**—hedge any currency or interest rate exposures the Issuer may have.

- **Cash Administrator**—provides banking and cash administration services to the Issuer.

- **Security Trustee**—acts as a trustee for the secured creditors of the Issuer (notably, holds the Issuer's assets granted to it as security for the Issuer's obligations, on behalf of the Investors).

- **Note Trustee**—acts on behalf of the holders of the asset-backed securities.

- **Auditors**—if necessary they audit the asset pool as may be required under the documentation of the relevant transaction.

History of Securitisation

- **USA:** The securitisation market began in the 1970's in the United States with the securitisation of residential mortgages by the Government National Mortgage Association. During the 1980's the market continued to develop in the United States with the introduction of new asset classes—in particular, auto loans and credit card receivables. It started to grow exponentially in the 1990's, expanding to virtually all types of assets which yield future cash flows.

  In the United States, the government has, through two government agencies, the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), been able to promote home ownership by stimulating the mortgage market. Fannie Mae and Freddie Mac buy mortgages from lenders and fund their activities by securitising those mortgages.

- **Europe:** In Western Europe the securitisation market developed in the late 1980's and early 1990's. The initial key asset classes were residential mortgages and consumer loans. It has rapidly developed in the 1990's particularly in the United Kingdom, France, Spain, the Netherlands, Belgium, Germany and Italy. Lately, securitisation has also been increasingly used as funding instrument by a number of European governments and other public authorities.

  In the United Kingdom, the government has used securitisation techniques to fund its "private finance initiative", a policy designed to privatise and outsource certain governmental functions such as building and operating prisons, hospitals and schools. Thus, for example, a number of hospitals in the UK have been built using funds raised in the capital markets by issuing asset-backed securities.

❖ ***Example:*** *One of the first, auto loan securitisation deal was a $60 million securitisation originated by Marine Midland Bank and securitized in 1985 by the Certificate for Automobile Receivables Trust.*

❖ ***Example:*** *The first significant bank credit card sale came to market in 1986 with a private placement of $50 million of outstanding bank card loans. After the success of this initial transaction, investors grew to accept credit card receivables as collateral, and banks developed structures to normalize the cash flows.*

Starting in the 1990's with some earlier private transactions, securitisation technology was applied to a number of sectors of the reinsurance and insurance markets including life and catastrophe. This activity grew to nearly $15bn of issuance in 2006 following the disruptions in the underlying markets caused by Hurricane Katrina.

Securitisation in India

- **Securitisation Act (2002):**
  As mentioned earlier, the process of Securitisation in India is governed by *The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002* (often referred to as Securitisation Act). Securitisation as a financial instrument has been in practice in India since the early 1990s – essentially as a device of bilateral acquisitions of loan portfolios of finance companies.

  The purpose of framing such an act is to promote the setting up of asset reconstruction/securitisation companies (known as ARCIL) *see Glossary* to take over the Non Performing Assets (NPA) accumulated with the banks and public financial institutions. The Act provides special powers to lenders and securitisation/ asset reconstruction companies, to enable them to take over of assets of borrowers without first resorting to courts. Thus, this law does very little for securitisation transactions and has been viewed as a law relating to enforcement of security interests.

  The implications of the act are as follows:

  1. **Taxation:** The tax laws have no specific provision dealing with securitisation. Hence, the market practice is entirely based on generic tax principles, and since these were never crafted for securitisations, experts' opinions differ.
  2. **Accounting:** The Institute of Chartered Accountants of India (ICAI) has come out with a guidance note on accounting for securitisation. Guidance notes are issued by the Research Committee of the Institute and are recommendatory rather than mandatory. But where a method is recommended, it is expected to be followed, unless there are reasons not to.

- **RBI Guidelines (2006):**
  The Reserve Bank of India (RBI) has recently notified the following guidelines under the Act for the regulation of securitisation companies:

  1. The Securitisation Companies and Reconstruction Companies (Reserve Bank) Guidelines and Directions, 2003.
  2. Guidelines to banks/Financial Institutions on sale of Financial Assets to Securitisation Company (SC) / Reconstruction Company (RC) (created under the Securitisation Act, 2002) and related issues, 2003.

  The implications of these guidelines can be analysed as follows:

  a) **Classification of Non-Performing Assets (NPAs):** The Guidelines seem to have made a significant departure from the definition of the NPA under the existing Reserve Bank of India (RBI) guidelines. As per the existing RBI guidelines, Receivables are to be treated as NPAs if the same remain overdue for a period of 180 days or more. But as per these new guidelines, the board of directors of a Securitisation (or Reconstruction) Company may, on default by the borrower, classify an asset as a non-performing asset even earlier that the said 180 days for the purposes of facilitating enforcement as provided for in Securitisation act †.

†*As per the Securitisation act: Where any borrower makes a default in repayment of a secured debt and his account is classified as an NPA, the secured creditor (or as the case may be the Securitisation Company) becomes entitled to exercise the recovery rights under the Act, after providing for a 60 day notice to the borrower.*

The Guidelines therefore permit a Securitisation (or Reconstruction) Company to classify a debt as an NPA and proceed to give the aforesaid 60 day notice under the Act immediately upon default by the borrower, without having to wait for the aforesaid 180 day period.

b) **Registration under the act:** The Guidelines clarify that a Securitisation (or Reconstruction) Company that has obtained a certificate of registration issued by the RBI under the Act can undertake both Securitisation and Reconstruction activities. The Guidelines also clarify that an entity that is not registered with the RBI may conduct the business of Securitisation or Asset Reconstruction outside the purview of the Act.

   Thus, in view of this clarification, banks and financial institutions that were engaged in securitisation activities prior to the Act can continue the same without having to obtain a certificate of registration under the Act. The benefits of the enhanced enforcement rights under the Act however, will not be available to them.

c) **Restrictions on raising monies from the public:** The guidelines prohibit a Securitisation (or Reconstruction) Company from raising monies by way of deposit. A Securitisation Company is permitted to raise funds from qualified institutional buyers (as defined in the Act) by issuing security receipts to them.

d) **Issue of security receipts:** The Guidelines state that security receipts are to be issued thorough one or more trusts set up exclusively for the purpose. The trusteeship of such trusts is required to vest with the Securitisation (or Reconstruction) Company. The Securitisation (or Reconstruction) Company is required to transfer the financial assets to the said trust at the price at which those were acquired.†

   † *It is important to note that this transfer of assets will double the incidence of stamp duty, as stamp duty will have to be paid in respect of the transfer of the financial asset from the originator to the Securitisation (or Reconstruction) Company, and also for the transfer of the financial asset from the Securitisation (or Reconstruction) Company to the trust.*

e) **Policies and plans required to be framed:** The Guidelines require that a Securitisation (or Reconstruction) Company shall formulate policies for asset acquisition, including valuation procedure, rescheduling of debts of borrowers (to be supported by an acceptable business plans, projected earnings and cash flows of the borrower), settlement of debts due from borrower, and plans for realisation of assets.

- **Securitisation volumes:**
  Securitisation volumes had been scaling new peaks every year. The party continued till about 2005. In early 2006, the RBI came out with guidelines on regulatory capital treatment for securitisation – these dealt a severe blow to the securitisation market and in 2006, the volumes are expected to be lower than those in 2005.

  The following table indicates the no. of securitisation transactions and the value of transaction in Rs. over a period of 6 years:

Number of securitisation Transactions						
Particulars	***FY2001***	***FY2002***	***FY2003***	***FY2004***	***FY2005***	***FY2006***
Asset Backed Securities issued	5	15	41	53	78	78
Volumes in Rs. (in billions)						
Particulars	***FY2001***	***FY2002***	***FY2003***	***FY2004***	***FY2005***	***FY2006***
Asset Backed Securities issued	NA	12.9	36.4	80.9	222.9	178.5

The above table clearly indicates that after the RBI guidelines in FY2006 the securitisation volumes have clearly declined.

Sometime back, Standard and Poor's (S&P) reported the Asian securitisation data for 2003, and it was a pleasant surprise to note that India was no. 2 in ex-Japan Asia in terms of volumes, next only after Korea. Though the gap between India and Korea is huge, but the
Indian market continued to zoom through 2004. Data for the first half of 2004-05 (upto Sept 2004) revealed that the market had already crossed a volume of Rs. 10,000 crores in the half year, which is nearly 4 times the volume for the same period last year.
In FY2004 and larger part of FY2005, volumes continued to surge.

Innovative transactions kept on emerging in the market. The scenario became really heated up with the Finance Minister announcing in his Budget Speech that (a) the definition of the term 'security' under the Securities Act will be amended to allow trading of securitisation instruments; (b) a committee to look into all aspects of bonds and securitisation transactions will be appointed.

In a nutshell: The new RBI guidelines seek to provide healthy and uniform directions for regulating securitisation activities. While these guidelines and the enhanced enforcement rights provided to Securitisation Companies under the Act will provide an impetus to securitisation in India, many legal impediments (hindrances) remain. Prominent among these legal impediments are the excessive stamp duty rates applicable to securitisation transactions in several states.

Most issuers will have to postpone new issuances in view of the RBI guidelines, which will surely slow down the market for some time. However, considering the booming economy and ever increasing volumes of foreign investment in the Indian capital market, the securitisation market may stabilize by 2007.

Risks involved in Securitisation

Does securitisation increase risk of the economic system?
The benefits of securitisation are, however, not unquestionable. Securitisation converts loan relationships into capital market commodities and therefore, increases the power of the capital market.

A debate on the potential risks of the capital market-financial market connectivity was initiated (or carried forward) by Prof Henry Kaufman. Prof Kaufman said: "The shift to marketable from non marketable assets brought about by securitisation has stretched credit creation. It tends to sustain borrowers longer in economic expansion and probably to expose them more in contractions. It also has had the important side effect of removing the illusion of price stability for non marketable assets. Some of the new securitised instruments have therefore magnified the volatility of financial asset prices."

Conclusion

As has been demonstrated in the case of several developed financial markets, asset securitisation is an important building block in creating an efficient and broad-based financial system. The concept is highly relevant to emerging economies, given their capital constraints. An enabling policy framework and affirmative actions in this regard from the government can immensely facilitate the development of the asset-backed securities market in India.

From an originator viewpoint, longer term advantages of securitisation are that, if used strategically, it will enable them both to grow and to create a sustainable competitive advantage. The growth will come from the funding flexibility it can provide, as the balance sheet will be less of a constraint and the demand for regulatory capital will be proportionately lower.

From a developmental perspective, it is absolutely vital to develop the domestic debt capital markets in the country in order to mobilise longer term savings. While pension funds, insurance companies etc may function as agencies of such resource mobilisation, it is important to create a range of high quality financial assets into which they can invest. These assets can in turn direct the mobilised resources to their appropriate destinations in the larger interests of the nation. Securitised debt backed by receivables from infrastructure financing may well be one category of such assets which could satisfy this requirement. Further, the ninth five year plan estimates the volume of resource requirements in the housing and infrastructure sectors to be of the order of Rs.150,000 crores and Rs.200,000 crores respectively. Such staggering numbers can be met only by speedier development of securitisation in the country.

Securitisation is expected to become more popular in the near future in the banking sector. Banks are expected to sell off a greater amount of NPAs to ARCIL by 2007, when they have to shift to Basel-II norms. Blocking too much capital in NPAs can reduce the capital adequacy of banks and can be a hindrance for banks to meet the Basel-II norms.Thus, banks will have two options- either to raise more capital or to free capital tied up in NPAs and other loans through securitisation.

❖ Glossary

- **Special Purpose Vehicle (SPV):** The word *"special purpose vehicle"* or *"special purpose entity"* is a buzzword in structured finance and can be potentially confusing.

  The word "vehicle" is a marketplace equivalent of "entity". Therefore SPV and SPE mean the same thing. As opposed to a general purpose vehicle or a trading corporation, a Special purpose vehicle, as the name suggests, is formed for a special purpose: therefore its powers are limited to what might be required to attain that purpose and its life is destined to end when the purpose is attained.

  A SPV is also called as a Securitisation Company (SC). However, when such deals are made in case of loans which are doubtful of recovery, the SPV is known as Reconstruction Company (RC).

  In India ARCIL is the SPV or Asset Reconstruction Company (ARC) for securitisation and reconstruction of financial assets.
  (Source: Misc. sources)

- **Qualified Institutional Buyers (QIBs):** A Qualified Institutional Buyer in law is a purchaser of securities that is financially sophisticated and is legally recognised by security market regulators to need less protection from sellers than most members of the public. For mutual funds it is generally an investor that is investing a large amount of money and presumably also meets the legal conditions in the country where the fund is located.
  (Source: Wikipedia)

- **ARCIL:** Asset Reconstruction Company (India) Limited (Arcil) is the first Asset Reconstruction Company (ARC) to commence business in India. ARCs are established to acquire nonperforming assets (NPAs) from financial institutions and banks with the objective of focused management of these assets and maximization of recovery. Relieving institutions and banks of the burden of NPAs should allow them to focus on core activities. Arcil has been set up to fulfil these objectives in the Indian banking landscape.

  Adopting a bank based model of ARC, Arcil has been sponsored by the significant players in the Indian financial sector, namely State Bank of India, ICICI Bank Ltd., IDBI Ltd. and Punjab National Bank.

  Arcil is registered with Reserve Bank of India (RBI) under Section 3 of the SRFAESI Act 2002 as a Securitisation Company (SC) and Reconstruction Company (RC) and commenced business with effect from August 29, 2003 and is a financial institution within the meaning of section 2(h)(ia) of the Recovery of Debts due to Banks and Financial Institutions Act, 1993. Arcil is also an Associate member of Indian Banks' Association.
  (Source: ARCIL website)

- **Pass through Certificate:** They are interests in a financial asset sold by a SPV to QIBs. Money collected by the SPV as monthly principal & interest payments from the borrower is distributed to those who own certificates.
  (Source: Misc. sources)

- **Non Performing Assets (NPA):** A loan or lease that is not meeting its stated principal and interest payments

- **Basel-II norms:** Basel II norms provide banks with guidelines to measure the various types of risks they face — credit, market and operational risks — and the capital required to cover these risks.

  BASEL-II norms are to banking what Duckworth-Lewis is to cricket. Both are complex, mathematically inclined, enigma for the layman but still very logical and needs some intuition to understand. Duckworth-Lewis changed the rules of the game and as Basel II is likely to do too.
  (Source: The Hindu Business Line Financial Daily)

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