

SECURITISATION

SECURITISATION: CONCEPT

Securitisation deals with the conversion of assets, which are not marketable, into marketable ones. Simply put, securitisation means the conversion of existing or future cash in-flows of any person into tradable security, which then may be sold in the market. The cash inflow from financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, fare collections become the security against which borrowings are raised. In fact, even individuals can take the help of securitisation instruments for better economic efficiency.

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.

A versatile financing tool, securitisation enables customization to meet client needs across a wide range of industries in a variety of financing situations with existing or future receivable cash flows. It offers many unprecedented benefits - the most significant being that the transaction can enjoy a credit rating much higher than that of the originator. This is because the lender is assured of regular cash inflows, there is an enhanced element of creditworthiness and therefore, the lender may be open to offering the loan at a lower rate of interest.

To cite an example, an individual having regular inflows by way of rent from property can raise a loan by offering his rent receivables as security i.e. the rent receipts will first be used to pay the loan and then for other purposes.

An established financing tool in developed economies, securitisation is fast becoming an increasingly important source of financing in emerging markets. Across the world, securitisation is being perceived as a means of providing access to diversified sources of funds.

SECURITISATION: INDIAN CONTEXT

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (“**Scarfaesi Act, 2002**”) deals with Securitisation.

As per Section 2 (z), "securitisation" means acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise;

Securitisation is particularly relevant in the Indian context, especially since growth in securitisation would add more high quality assets to the fixed income market and would also provide the much-needed fillip to infrastructure financing. Off late, there has been a trend of getting a higher credit rating and cheaper borrowings through the use of securitisation instruments.

BENEFITS OF SECURITISATION

The importance of securitisation lies in the fact that it helps convert illiquid assets or future receivables into current cash inflows and that too at a low cost. The company may sell the receivables in the market and raise loans.

ELIGIBILITY

Section 5 of the Scarfaesi Act, 2002 provides that only banks and financial institutions can securitise their financial assets and only a securitisation company¹ or an asset reconstruction company can acquire such financial assets.

PURPOSE OF SECURITISATION:

Banks and financial institutions give loans to consumers and receive the amount back in installments with interest at mutually agreed terms. Now these loans are called financial receivables or assets. These funds will be received by the bank over the years, however, if the bank wants instant cash or if the bank feels that the return on these financial receivables are irregular, or a proportion of such loans has become non performing and categorized under NPA category, the bank may sell these assets to another bank or financial concern at a cheaper rate in return for instant cash.

Securitising such financial receivables can only satisfy this need for instant cash.

PROCEDURE

These blocked funds (financial receivables) are freed by transferring the assets of the Originator (the person who holds the assets) to a Special Purpose Vehicle (“SPV”).

The SPV is a separate entity formed exclusively for the facilitation of the securitisation process and providing funds to the originator. The assets being transferred to the SPV need to be homogenous in terms of the underlying asset, maturity and risk profile. What this means is that only one type of asset (eg: auto loans) of similar maturity (eg: 20 to 24 months) will be bundled together for creating the securitised instrument.

¹ "Securitisation company" means any company formed and registered under the Companies Act, 1956 (1 of 1956) for the purpose of securitisation; (Section 2 (z) of Scarfaesi Act, 2002).

The SPV will act as an intermediary, which divides the assets of the originator into marketable securities. The people who buy such marketable securities are called the Investors.

These securities issued by the SPV to the investors are known as pass-through-certificates (“PTCs”). A Pass Through Certificate is an instrument, which signifies transfer of interest in the receivable in favour of the holder of the Pass Through Certificate. The investors in a pass through transaction acquire the receivables subject to all their fluctuations, prepayment etc. The material risks and rewards in the asset portfolio, such as the risk of interest rate variations, risk of prepayments, etc. are transferred to the investors.

Similar to PTCs, investors may also opt for Pay Through Certificates. Pay Through Certificates are instruments, which instead of giving the investor undivided interest on securities, give them debt securities, which are backed by mortgages transferred by the originator to the SPV. These debt securities are again payable on fixed dates.

The Cash Flows (which will include principal repayment, interest and prepayments received) received from the Obligors (obligors are the consumers who will remit the installments in the name of the Financial Institution or bank from whom they’ve taken loans) are passed onto the investors (investors who have invested in the PTCs) on a pro rata basis once the service fees has been deducted.

There are also Pay Through Certificates where the investors instead of being given the undivided interest on securities are given debt securities, which are backed by mortgages transferred by the originator to the SPV. These debt securities are again payable on fixed dates.

The difference between rate of interest payable by the obligor and return promised to the investor investing in PTCs is the servicing fee or remuneration for the SPV. Besides, the

pool of financial receivables, the SPV should also be credited by about 10% additional collateral by the originator as a safety measure.

Once assets are securitised, these assets are removed from the bank's books and the money generated through securitisation can be used for other profitable uses such as giving new loans.

The administrator or the servicer is appointed to collect the payments from the obligors. The servicer follows up with the defaulters and uses legal remedies against them. The SPV can have a servicer to collect the loan repayment installments from the people who have taken loan from the bank. Normally the originator carries out this activity, SPV merely holds the money as a trustee for the investors.

EVALUATING THE SECURITISED INSTRUMENTS:

In order to facilitate a wide distribution of securitised instruments, evaluation of their quality is of utmost importance. This is carried on by rating the securitised instrument, which will acquaint the investor with the degree of risk involved. Any recognized body such as CRISIL may do the ratings. The rating agency rates the securitised instruments on the basis of asset quality, and not on the basis of rating of the originator. So particular transaction of securitisation can enjoy a credit rating, which is much better than that of the originator.

High rated securitised instruments can offer low risk and higher yields to investors. The low risk of securitised instruments is attributable to their backing by financial assets and some credit enhancement measures like insurance/underwriting, guarantee, etc used by the originator.

For an originator, securitisation is an alternative to corporate debt or equity for meeting its funding requirements. As the securitised instruments can have a better credit rating

than the company, the originator can get funds from new investors and additional funds from existing investors at a lower cost than debt.

PROCEDURE AT A GLANCE

- (i) The originator determines which assets he wants to securitise for raising funds.
- (ii) The SPV is formed.
- (iii) The SPV is funded by investors and issues securities to the investors.
- (iv) The SPV acquires the receivables under an agreement at their discounted value.
- (v) The servicer for the transaction is appointed, normally the originator.
- (vi) The debtors are /are not notified depending on the legal requirements.
- (vii) The servicer collects the receivables, usually in an escrow mechanism, and pays off the collection to the SPV.
- (viii) The SPV either passes the collection to the investors, or reinvests the same to pay off to investors at stated intervals.
- (ix) In case of default, the servicer takes action against the debtors as the SPV's agent.
- (x) At the end of the transaction, the originator's profit, if retained and subject to any losses to the extent agreed by the originator, in the transaction is paid off.

ASSET RECONSTRUCTION COMPANIES

Securitisation also helps banks to sell off their bad loans (NPAs or non performing assets) to Asset Reconstruction Companies (ARCs). ARCs, which are typically publicly/government owned, act as debt aggregators and are engaged in acquiring bad loans from the banks at a discounted price, thereby helping banks to focus on core activities.

On acquiring bad loans ARCs restructure them and sell them to other investors as PTCs, thereby freeing the banking system to focus on normal banking activities.

Asset Reconstruction Company of India Limited (ARCIL) was the first (till date remains the only ARC) to commence business in India. ICICI Bank, Karur Vysya Bank, Karnataka Bank, Citicorp (I) Finance, SBI, IDBI, PNB, HDFC, HDFC Bank and some other banks have shareholding in ARCIL. A lot of banks have been selling off their NPAs to ARCIL. ICICI bank- the second largest bank in India, has been the largest seller of bad loans to ARCIL last year. It sold 134 cases worth Rs. 8450 Crore. SBI and IDBI hold second and third positions.

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.

FOREIGN PARTICIPATION IN ARCS:

As for foreign participation in ARCs, RBI/2005-06/203 A.P. (DIR Series) Circular No. 16 issued on November 11 2005 clarifies that Maximum foreign equity shall not exceed 49% of the paid up equity capital of the ARC. Where investment by any individual entity exceeds 10% of the paid up equity capital, ARC should comply with the provisions of

Section 3(3) (f) of the Scarfaesi Act, 2002². While considering foreign equity, foreign institutions are not included and are not permitted to invest in the ARC.

General permission has also been granted to Foreign Institutional Investors (FIIs) registered with Securities and Exchange Board of India (SEBI) to invest in Security Receipts (SRs) issued by Asset Reconstruction Companies (ARCs) registered with RBI. In any scheme relating to the issue of Security Receipts, FIIs have been permitted to collectively invest upto 49 per cent in each tranche of the scheme subject to condition that the investment by a single FII shall not exceed 10 per cent of the issue.

² Section 3 (3) The Reserve Bank may, for the purpose of considering the application for registration of a securitisation company or reconstruction company to commence or carry on the business of securitisation or asset reconstruction, as the case may be, require to be satisfied, by an inspection of records or books of such securitisation company or reconstruction company, or otherwise, that the following conditions are fulfilled, namely:—

(f) that a sponsor, is not a holding company of the securitisation company or reconstruction company, as the case may be, or, does not otherwise hold any controlling interest in such securitisation company or reconstruction company;