UNIT 14 ASSET SECURITISATION

Objectives

After reading this unit, you should be able to :

- understand the meaning of asset securitisation;
- describe various benefits of securitisation;
- appreciate the different instruments of securitisation;
- explain various steps involved in the process of securitisation; and
- analyse the developments in securitisation in the Indian market.

Structure

14.1 INTRODUCTION

Owing to the deregulation of the markets and competitive business environment in the market, banks and financial institutions have been under pressure to improve their financial performance. This is possible only if lending institutions are prepared to take more risk. In other words, such institutions will be able to earn more profit by undertaking more risk.

The banks and financial institutions are required to deal with various types of risk such as market risk comprising of liquidity and interest rate risk, credit risk and currency risk, etc.

They are required to design and implement an appropriate risk management system which will help them to quantify and control various types of risks. As banks and financial institutions are involved mainly in lending business, they have to deal with credit risk and liquidity risk of their lending portfolio. In this regard, banks and financial institutions can make use of asset securitisation as hedging instrument to manage both liquidity and credit risk of loan asset. With the help of such product, lending institutions will be able to sell loan asset thereby improving their liquidity position. The cash generated from such assets will be used to create either new loan assets or other assets. Similarly, lending institutions would like to sell loan assets for cash without recourse so as to pass on credit risk to the buyer of the loan assets. All this is possible by using asset securitisation product for loan asset portfolio. Asset securitisation has become very popular product in most of the developed countries. In developing countries like India asset securitisation is a new product which need to be encouraged by the Government and market regulator through an appropriate policy framework. The various aspects of asset securitisation are discussed below under various heads.

14.2 MEANING OF SECURITISATION

Asset securitisation is defined as a process whereby assets like loans and receivables are used to create and sell asset backed securities. The assets which can be used for securitisation include receivables from the government departments, loan assets like housing loan and automobile loans, leased assets and credit card receivables etc. In fact, any asset can be considered for securitisation provided it is possible to forecast future cash flows to be generated from such assets with reasonable accuracy. In a nutshell, asset securitisation can be defined as the process which takes place when a lending institution's assets are removed in one way or another from the balance sheet of that lending institution and are funded instead by investors who purchase an instrument created from these assets without recourse or with recourse towards seller of the asset (i.e., originator's of the asset). The yield to the investors is set at a market level appropriate to the characteristics and the quality of the asset pool. Thus, under asset securitisation a bank or lending institution like financial institution sells loan assets and receivables to an independent entity like special purpose vehicle (SPV) who pools and packages individual loans and receivables and creates securities against them, gets them rated and sells them to the investors at large through public offerings or private placements (Trustee). The future cash flow (to be received by originator of a loan) are remitted to the trustee who in turn pays agreed interest and principal amount to the investors as per the terms of an agreement. Thus, "**Asset Securitisation is a synthetic technique of converting illiquid assets into liquid assets through the process of issuing securities to the investors by SPV"** thereby providing market determined yield on such securities and marketability in respect of such instruments. The whole process of asset securitisation is beneficial to both lending institutions (originator's of loan) as well as to the investors.

In a securitisation exercise, the underlying assets are used both as a collateral to the security and also to generate the income to pay the principal and interest on such securities. This is in contrast to a traditional secured debt instrument where the debt may be serviced from not only the income generated from the assets secured, but also from the entire operations of the issuers. Further under securitisation having characteristic of without recourse the credit risk is shifted completely from the originator of the loan assets to SPVs.

In order to get the full benefits of securitisation, it needs to be considered as a structured financial product and accordingly a systematic methodology needs to be followed based on certain parameters. Few of these parameters are given below :

1) The cash flows from the underlying assets are packaged to attract targeted investors.

2) The tax and accounting needs of the issuers and investors are satisfied.

3) The criteria for choosing the pool of assets so as to ensure minimum cost of funds.

4) A bankruptcy or a winding up of the originator does not have any impact on the cash generated from assets and use of the same to make payment to the investors.

14.3 BENEFITS OF SECURITISATION

To the Issuers

To improve capital adequacy ratio: Banks and financial institutions are required to maintain certain minimum capital to risk weighted assets ratios pursuant to the Basel Committee's guidelines applicable to them. Loan portfolio carries 100 per cent risk weightage. By securitising such portfolio, it is possible for the banks and financial institutions to remove this asset from their balance sheet. The cash generated from such process can be invested in lower risk weighted assets. Thus asset securitisation will help the issuer to improve the capital adequate ratio.

To ensure proper asset liability management: Securitisation of loan assets will improve the cash position and thus ensure adequate liquidity position of the originator. This will help the organisations like banks and financial institutions to adjust asset mix quickly and efficiently. Further, these organisations will not require to depend on traditional high cost sources of borrowed funds. As the funds raising through securitisation is independent of the originator's rating, securitisation will help the issuer to raise funds at a cost which is significantly lower than the commercial rate of borrowing. This will improve the spread between interest income and interest expense.

Issuer is in a position to improve income: as he can charge one time fee for processing loans and also can recover the charges from SPV for providing administrative services in respect of securitised assets. Further, profits on securitised assets are booked upfront. This leads to an improvement in the originators profitability resulting in improved financial performance.

Risk Diversification: Securitisation allows the issuer to manage its credit exposure to a particular borrower as well as sectors and thus helps in risk reduction and diversification.

There are no reserve requirements either in the form of cash reserve and statutory liquidity ratios for cash generated through securitisation by banks as originators.

New loans with same liabilities: Under securitisation, deposit liabilities need not go up and by selling illiquid assets, banks can reduce their existing debt. The cash flows obtained by selling illiquid assets under securitisation can be used to lend funds further at a higher rate. Therefore, against the same amount of liabilities, banks and financial institution will able to create new qualitative assets again and again.

To Investors

Good Liquidity: As the securitised paper is rated by a credit rating agency, such instrument enjoys liquidity in the secondary market. In vies of this, investor especially institutional investor can look upon investment in such instrument as a source of liquidity.

Safety: Asset back securities with credit enhancement are preferred mainly by those investors who are interested only in safety of the investment and are not prepared to take more risk. This is so because such securities provide high degree of safety.

Increased Yield: The yield on these securitised papers which are actively traded in the secondary market seems to be higher as compared to the yield on other corporate debt instruments. In view of this, investor can receive higher yield on such instruments.

Diversification: Investment in securitised paper helps to diversify portfolio risk. This is so because asset securitisation involves pooling of different kinds of assets belonging to different geographical areas.

To the Financial System

Lowered Cost: Introduction of securitisation product in the market will help to bifurcate the process of lending and funding into several discrete steps leading to specialisation and economies of scale. This will result in lower costs for the economy as a whole and in the ultimate analysis this will help to bring down cost to the customers.

Flow of Funds: Securitisation process helps to generate more funds for the economy. This assumes significance in the light of the fact that developing economy as a whole as well as specific sectors such as housing and infrastructure are always faced with the problem of resource constraints. Securitisation facilitates flow of funds from capital surplus to capital deficient segments.

Stability: Various risk which are normally found in case of banking business such as credit, liquidity, interest rate risk, etc., can be segregated through securitisation and can be distributed accordingly to market intermediaries equipped to absorb them most efficiently. This leads to a more stable financial system.

Effect on Market: With the introduction of securitisation product and active secondary market for securitised instruments or papers the debt market in the economy as a whole is likely to attain further depth and become vibrant. This fact has been borne out by the experience in other countries.

14.4 TYPE OF ASSETS WHICH CAN BE SECURITISED

For an asset to be securitised it must fulfil certain conditions. Few of these conditions are given below :

1) The future cash flows of the asset to be securitised should be dependent on such assets (i.e. cash need to be generated from the same asset). It should be ensured that previous instalments (i.e. cash flows) were paid in accordance with a determinable and a demonstrated historical payment pattern.
2) The asset should be of good quality and readily marketable, either on its own merit or with some form of credit enhancement so that the risk of default is substantially reduced.
3) The pool of assets must have similar interest payment dates and maturities.
4) The value of assets to be securitised must be large enough to make the transaction economically viable keeping in view the cost and benefits of such transactions.

Activity 1

Enumerate the benefits of securitisation to the issuers.

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14.5 ORIGIN OF SECURITISATION

The asset securitisation market developed first in the USA in early 1980s with securitisation of home loans by the Government National Mortgage Association and The Federal Home Loan Mortgage Corporation. The securitisation process was carried out by issuing a new financial instrument known as Passing Through Certificate (PTC). The insurance companies, commercial banks, and other financial institutions made investment in PCT. However, pass through certificates were less popular with long term investors such as pension funds because of pre-payment risk.

Securitisation worked so well in USA with the residential mortgages that in mid of late 1980s, it spread to other types of loans. Securitisation of other types of loans were driven by the desire of banks to get their assets off their balance-sheets in order to improve their capital ratios. Computer leases were the first non mortgage loans to be securitised, soon followed by automobile loans, and then credit guaranteed receivable ('Plastic Bonds') and commercial mortgages and other lease contracts. Efforts were made to securitise trade credit and commercial loans.

At present USA is the largest securitisation market in the world. In terms of depth, it is the only market where the securitisation market draws participation from institutional as well as individual investors. Around 75 per cent of the global volumes in securitisation are originated from the USA. Apart from mortgage backed loan assets, other assets like credit card loans, automobile loans have also become major assets for securitisation. It is interesting to note that alongwith standard assets, non-performing assets of banks and financial institution have also been securitised in USA. The securitisation market in USA has been more liquid, innovative and sophisticated.

Securitisation in the modern sense emerged in Europe in the mid 1980 with the issuance of Mortgage Backed Securities in UK. The first deal of securitisation was done by Bank of American Finance Limited, UK in January 1985 using residential property mortgages as underlying assets. In UK a high preference for ownership of assets resulted in a continuous demand for funds, leading to a need for continuous supply of funds. Securitisation was the proper answer to this. However, it could develop and succeed only because of simple legal procedures and fast decisions taken by judiciary.

14.6 PROCESS AND MECHANISM OF SECURITISATION

- An institution like bank which own the assets and which wants to raise cash through securitisation is required to identify homogeneous loan assets. Such assets are pooled together by using parameters like type of credit facility, tenor of loan and nature of credit risks etc.
- The receivables, representing cash flow from loans assets, are pooled together and are transferred to a newly formed independent institution called a special purpose vehicle (SPV) which will be created either in the form of a trust or a registered company.
- SPV which is created specifically for securitisation issues the securities to the prospective investors. The securities so issued are known as pass or pay through certificates.
- The securities are issued from pool of assets by SPV with or without recourse to the originator of loan asset.
- In order to enhance credit worthiness and liquidity position, SPV enter into an agreement with non life insurance companies to absorb credit risk and obtain a line of credit from banks to make available cash for payment.

- In order to make the issue attractive SPV obtains credit rating for securities to be issued from pool of assets from recognised credit rating agencies. This also improves liquidity for such instrument in the secondary market.
- The securities are issued to the investors through public issue or by private placement. SPV take the help of merchant bankers for selling of these securities to the prospective investors.
- Investor can hold these securities till its maturity. On maturity, securities are redeemed by the SPV (i.e. issuer) along with interest due on such securities. As many of these pass or pay through certificates are traded in the secondary market, investor can avail liquidity by selling such certificates in the secondary market.

Activity 2

List the various steps involved in the process of securitisation.

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14.7 PARTIES INVOLVED IN TRANSACTION OF ASSET SECURITISATION

Originator

Originator is the owner of the loan asset. He is required to identify receivables or loan assets which will be used for securitisation purpose.

Special Purpose Vehicle (either trust or a registered company)

Special purpose vehicle is created through a trust or a registered company. SPV is involved to buy the loan assets and to issue securitised instruments to the investors.

Merchant Bankers

Merchant bankers provide necessary support in structuring a securitised deal. He is responsible to bring together the originator, credit rating agency, investors and others who are involved in securitisation deal. They also help in marketing these securities to the prospective investors. Many times merchant bankers provide underwriting support to the whole issue of securitised instruments. He also provides liquidity to the investors by becoming a market maker in respect of securities instrument issued by SPV.

Rating Agencies

Rating agencies assess credit quality of securitised instruments and assign appropriate rating symbol to such instruments. The rating process would assess the strength of the cash flow and the mechanism designed to ensure full and timely payment by the process of selection of loans of appropriate credit quality, the extent of credit and liquidity support provided and the strength of the legal framework.

Investors

The investors may be in the form of individuals or institutional investors such as financial institutions, mutual funds, banks, pension funds and insurance companies etc. They buy a participating interest in the total pool of receivables and receive their payment in the form of interest and principal as per the terms of an agreement.

Obligor(s)

The obligor is the originator's debtor (i.e. borrower of the original loan). The outstanding loan amount in the account of borrower is the asset which is transferred to SPV. The credit standard or rating of the obligor(s) is of paramount importance in a securitisation deal.

Administrator or Servicer

Many times originator of a loan asset act as an administrator. His role is to collect the payment due from the obligor(s) and passes it to the SPV. In case borrowers refuse to make payment then an administrator is required to follow up the recovery with defaulting borrowers and in case if need arise, it requires to pursue legal remedies for collection of money.

14.8 ROLE OF SPECIAL PURPOSE VEHICLE (SPV)

The Special Purpose Vehicle (SPV) is created to purchase the assets from the Originator and issue securities against these assets. Such a structure provides a comfort to the investors that they are investing in a pool of assets which is held on their behalf only by the SPV and which is not subject to any subsequent deterioration in the credit quality of the originator. SPV may be created either as a trust or registered company. However, quiet often SPV is structured as a trust to take advantage of tax benefits. By and large SPV is created by the originator of the loan asset. However, due to independent legal entity ownership and management of SPV are independent of the originator. Due to the limited scope of its activities, it has no bankruptcy risk.

SPV should have the following characteristics :

- A SPV must be capable of acquiring, holding and disposing of assets.
- It would be an entity which would undertake only the activity of asset securitisation and no other activity.
- It should be independent of bankruptcy of the originator (i.e. the bankruptcy of originator should not affect the interest of holders of instruments issued by SPV).
- A SPV must be able to undertake multiple securitised transactions of asset securitisation.

14.9 INSTRUMENTS OF SECURITISATION

The following types of securities are structured in asset securitisation.

a) Pass and Pay Through Securities.

b) Asset and Mortgage Backed Securities

a) Pass and Pay Through Securities

The nature of the investors interest in the underlying assets determines whether a securitisation structure is a 'Pass Through' or Pay Through structure.

Under pass through securities structure, the originator sells the assets to be securitised to the SPV. As a result assets are removed from the balance sheet of the originator. The originator acts as servicer and passes on the interest and principal amount collected. The seller of the asset (i.e. originator) transfer the entire cash flows accruing from the assets to the discharge of obligation. The sale of assets, to SPV improves the liquidity position and liquidity ratio of the originator. Pass through securities represent a direct claim of the investors on all that the SPV collects from these assets transferred to it. In other words, such securities carry proportional beneficial interest in the assets held by the SPV.

In a pass through structure, the SPV issues 'pass through certificates' which are in the nature of participation certificates that enable the investors to take a direct exposure on the performance of the securitised assets.

SPV also issues pay through securities. Such securities give investors only a charge against the securitised assets while the assets themselves are owned by the SPV. The SPV issues regular secured debt instruments. In other words pay through securities are essentially the obligations of the SPV which are discharged out of the receivables collected from transferred assets.

Pay through structures permit de-synchronisation of servicing of the securities from the underlying cash flows. Thus the SPV is given discretionary power to reinvest short term surplus according to its requirement. This structure enables SPV to offer wide range of instruments with different maturities and yields. Thus SPV is free to restructure the cash flow from the receivable into payments on several debt trenches with varying maturities.

b) **Asset and Mortgage Backed Securities**

Securities issued by the SPV in a securitisation transaction are referred to as Asset Backed Securities (ABS) because investors rely on the performance of the assets that collateralise the securities. They do not take an exposure either on the previous owner of the assets (the Originator), or the entity issuing the securities (the SPV). Clearly, classifying securities as 'asset-backed' seeks to differentiate them from regular securities, which are the liabilities of the entity issuing them.

In practice, a further category is identified – securities backed by mortgage loans (loans secured by specified real estate property, wherein the lender has the right to sell the property, if the borrower defaults). Such securities are called Mortgage backed Securities (MBS). The most common example of MBS is securities backed by mortgage housing loans. All securitised instruments are either MBS or ABS.

14.10 WITH RECOURSE AND WITHOUT RECOURSE SECURITISATION

With Recourse Securitisation

The lending institution engaged in securitisation or SPV may enjoy recourse to the seller of the asset in case of failure of customers to repay dues on due dates. In this case the lending institution (i.e. seller of the asset) is unable to pass on credit risk to SPV. In this case SPV enjoys lesser margin. Under this method seller becomes the servicer. He collects the cash flows from lessee, hire purchaser or borrower and pass on the cash to the SPV. The SPV merely passes the funds to the investors. In this arrangement, securitised assets creates off balance sheet liability to the seller of the assets.

Without Recourse Securitisation

The securitisation without recourse will help the originator to sell the loan assets to the SPV with credit risk also. The collateral may be designed to have a bankruptcy structure to enjoy all the rights which the seller would have enjoyed on the leased/hire purchase in case of failure of the customers to pay lease rentals and hire purchase instalments. In other words SPV absorbs the credit risk. Assets in the nature of receivables which are designed as collateral are assigned in favour of SPV. By virtue of this assignment, SPV has a right to collect cash on due date from the borrowers who have defaulted in payment of cash.

Activity 3

State whether the following statements are true or false.

1) Securitisation is not a credit derivative product. True/False

2) Only loan assets of banks and financial institutions can be considered for securitisation. True/False

3) Securitisation can be considered with recourse only. True/False

14.11 CRITERIA FOR INVESTMENT IN SECURITISED INSTRUMENTS

While investing funds in securitised papers, the following criteria can be used by the investors.

i) Safety (credit risk)

ii) Liquidity

iii) Rate of Return

i) **Safety of Investment:** In order to ensure safety of investment in securitised papers, it is better to use credit rating attached to such instruments. SPV prefer to have credit rating from recognised rating agencies for such instruments. Investment in securitised papers with higher credit rating will help to mitigate credit risk. This further can be eliminated by investing in securitised papers having with recourse characteristic.

ii) **Liquidity of Securitised Papers:** Investment decision is also influenced by liquidity or marketability of securitised instruments. Investor would like to invest in that securitised paper for which there is active secondary market. Because of good rating from rating agencies and backing of assets, securitised instruments are likely to carry more liquidity in the market. For this purpose there is a need to develop a good secondary market which will facilitate early transfer of assets to the buyer.

iii) **Rate of Return:** It has been observed in developed countries where securitisation has taken place, that Pass Through Certificates (PTC) have been fetching higher yield than the yield on government securities. This combined with a high degree of liquidity has made the PTCs instruments very popular among investors. To make these certificates "take off' in Indian financial market such instruments must offer adequate rate of return, vis-à-vis, return on other comparable financial instruments. The return would have to be much higher to compensate for the lack of liquidity, at least initially, till an active secondary market is developed in these instruments.

14.12 GROWTH OF SECURITISATION IN INDIAN MARKET

Securitisation is a relatively new product of structured finance in India. Slowly and steadily the market for such product has been picking up.

The first securitisation deal was made by Citi Bank in respect of its auto loan portfolio and the bank placed the paper with GIC Mutual Fund. This programme was rated by CRISIL Ltd. Subsequently, Citi Bank helped ICICI Ltd. to scrutinise latter's loan portfolio. Since then, securitisation of assets has begun to emerge as one of the important option for resource mobilisation by banks, non-banking finance companies and others. Not only banks and non-bank finance companies, many manufacturing companies and service industries have been engaged to securitise their deferred receivables and future cash flows also. In the context of rated transactions CRISIL has rated large number of transactions. Other rating agencies like ICRA, DCR and CARE have also been actively involved in the securitisation process.

At present the securitisation market is dominated by finance companies and banks which have used this structured product to book profits and as a cost effective source of funding rather than for purposes of capital relief. In the past receivables arising from hire purchase transactions used to be securitised on a large scale. Out of the total asset securitisation attempted between 1992 and 1998 as much as 35 per cent transactions were related to hire purchase receivables of truck and auto loan segments.

Non banking finance companies have been showing interest in asset backed securitisation, while the investors enjoyed a higher yield, the cost of securitisation to NBFCs was lower than the traditional sources such as bank loans and public deposits. Commercial banks as well as housing finance companies have shown preference for mortgage backed securitisation process to securitise their housing loan portfolio.

In order to ensure proper development of securitisation as a structured product in Indian market RBI appointed working Group on Asset securitisation and submitted its report in 1999. The said committee has made several recommendations. Few of these recommendations are given below :

1) Inclusion of securitised instruments in Securities Contract Regulation Act.
2) SEBI may consider removal of prohibition on investment in mortgage backed securities by Mutual Funds Schemes.
3) Need to spell out risk weights and NPA norms on securitised paper.
4) Insurance companies and provident funds need to be encouraged to invest in the securitised paper. Besides, suitable regulatory framework may have to be evolved to encourage foreign institutional investors to invest in securitised instruments.
5) Listing requirements for various securities to be issued may be stipulated which may include minimum issue size, eligible stock exchanges etc.
6) Include the securitised paper in demat trading.

14.13 FUTURE PROSPECTS

The securitisation as a structured finance product will grow in Indian market in future because of the following reasons :

1) Because of strict capital requirements as per Basel Accord II banks and financial institutions will require to go in for securitisation in respect of their credit portfolio.
2) Securitised paper is rated more creditworthy than the originator of the loan asset.
3) Issue of securitised paper by the SPVs in the market will lead to the widening and deepening of debt market in India. With the large number of institutional investors in the market, secondary market for such paper will also get developed in due course of time.

4) A well developed financial system in India comprising of financial institutions, financial markets and special regulators.

5) The existing specialised financial institutions, like housing finance companies, urban infrastructure development bodies who not only have existing securitisable portfolio but also have the capacity to keep creating such assets with a view to securitising them. By undertaking securitisation process, these institutions will overcome the problem of recourse constraints and thus they will be able to focus on their core competency of supporting infrastructure projects.

14.14 SUMMARY

Asset Securitisation is a process wherein loan assets and future receivables arising on account of trade and business activities are packaged, underwritten and sold in the form of securities. The various parties namely the originator (seller of loan assets), trust or company (special purpose vehicle), merchant bankers, rating agencies and institutional investors etc. are involved in the process of securitisation. Securitisation of loan assets and receivables can be done with recourse or without recourse. Three instruments namely, pass through certificates, pay through certificates and stripped securities are used in the securitisation process.

In India, the first securitisation deal was made in 1991 between ICICI Ltd. and Citi Bank to securitise loan assets of ICICI Ltd. Since then the market for securitisation has been growing slowly but steadily. Many commercial banks and housing finance companies have securitised their loan portfolio. India is likely to witness considerable growth in securitisation market in near future.

14.15 SELF ASSESSMENT QUESTIONS

Give brief answers for the following questions:

1) What do you mean by securitisation?
2) Explain various benefits of securitisation to originators and investors
3) Explain the process of securitisation
4) Define the role of various parties who are involved in securitisation process.
5) What are the various instruments of securitisation?
6) Explain the features of asset securitisation as a structured financial product in Indian market.

14.16 FURTHER READINGS

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