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Securitization in India: A Strategic Tool for Competitiveness

KEYWORDS: securitization, special purpose vehicle, structured finance, Asset Backed Securities, Mortgage Backed Securities

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ABSTRACT *Securitization is an American invention, but no longer remains an American curiosity. Almost every country's financial systems have certain securitization schemes. Today, securitized assets not only include mortgages on properties, but also credit card receivables, computer leases, equipment notes financing, auto loans, and even future sales of music records. There was even an attempt to securitize the life insurance policies of people with full-blown AIDS, enabling them to monetize their policies. Securitization has emerged globally as an important technique for bundling assets and segregating risks into marketable securities. It involves parceling and selling pools of eligible assets by the company owning the assets to a Special Purpose Vehicle (SPV) company, which issues debt securities to finance the purchase of such assets. This paper will discuss the present nascent state of the securitization market in India, its potential and attempts to identify what needs to be done by various stakeholders in this market for securitization to grow into its full potential. The paper will attempt to explain the growth of securitization in different markets, elaborating on the process, reasons for securitizing assets, benefits of and requirements for a successful asset securitization focusing on India with special reference to SARFAESI Act 2002.*

Introduction: Securitization as a mode of structured finance

Securitization facilitates creation of new securities which comes under the discipline of financial engineering. Securitization process can be defined as process of pooling of assets, packaging them into tradable securities and distributing the same to the ultimate consumers. Jobst, 2006a, in his work, "Sovereign Securitization in Emerging Markets," Journal of Structured Finance, defined asset securitization as a process that converts a pool of designated financial assets into tradable liability and equity obligations as contingent claims backed by identifiable cash flows from the credit and payment performance of these asset exposures. Securitization is the process of converting an existing asset or a cash flow into a marketable security. For example, for a bank or non-banking finance company (NBFC), loans are assets since they earn interest (cash flow). Securitization of such assets refers to converting them into marketable paper securities and selling them to another entity (or investor) and thereby transferring the future cash flows to the buyer for a price. Part of the reason for the sub-prime mortgage crisis in the US was the widespread securitization of mortgage-backed loans. The basic purpose of securitization is to reward the comparative advantage of a bank to originate loans, compared with its ability to service the loans and its ability to bear the risk associated with those loans. In securitization, banks sell a pool of loans (assets) to a special purpose vehicle (SPV) that in turn issues claims or securities on the underlying pool of loans.

Process of Securitization: According to John Henderson & Jonathon Scott, it is a process which takes place when a lending institution's assets are removed in one way or the other from its balance sheet and are funded instead by the investors who purchase a negotiable financial instrument evidencing this indebtedness, without recourse to the original lender. The process of securitization primarily involves three parties namely, the originator, the special purpose vehicle (SPV) and the investor. The originator is the one who owns the financial asset and who wants to offload the same in the market. The originator could be a banking, industrial or finance company. The SPV or in other words the issuer is the one who issues mortgage-backed securities to investor in the market. Generally merchant bankers function as SPV's. Following is the three stages involved in the process of securitization:

Stage 1: Asset Identification: The 'originator', first identifies the asset or a pool of assets that have to be securitized. There must be some basic conditions that must be satisfied by an asset, which is to be securitized. For instance, the cash flows from the reference asset should be reliable and payments should be periodically obtained. This means that the asset portfolio should have a documented history showing default and delinquency experience. The assets have to be of good quality that in turn facilitates the marketability to be quick and easy. This is to ensure that default risks are brought down considerably. The pool of assets should carry identical dates of interest payment and maturities. Assets that stand a chance of being sold to investors ideally should have the features like: a) be well diversified; b) Have a statistical history of loss experience; c) be homogenous in nature;

d) be broadly similar in repayment and final maturity structures; e) be to some extent liquid

Stage 2: Structuring the Asset Backed Securities (ABS): In a typical securitization deal, the asset originator creates a SPV and sells reference assets to the same. The SPV can either be a trust, corporation or form of partnership set up specifically to purchase the originator's assets and act as a conduit for the payment flows. Payments advanced by the originators are forwarded to investors according to the terms of the specific securities. The SPV then structures the ABS based on the preferences of the originator and the investors. To make the ABS attractive to the investors, issuers follow some credit enhancement procedures. Credit enhancement in securitization is a way of increasing the credit quality of the security above the original loan pool to increase the likelihood of buyers receiving payment. After structuring the ABS, they are offered to the investor public through a merchant banker. The issuer takes up the responsibility of creating a market in the securities that are created. However, as per the RBI Guidelines on Securitisation issued in May 2012 prohibit stipulation of credit enhancement for assignment transactions, thus exposing the purchasing banks to the entire credit risk on the assigned portfolio.

Stage 3: Investor Servicing: The investor is serviced by periodic payments depending on the nature of the ABS. According to the terms of the issue, the investor may be paid interest periodically and the principal at the end of the maturity as a bullet payment. Or they may be paid both interest and

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principal periodically over the period of maturity. Investors buy this risk if they see the risk as a diversifying asset, the risk premium demanded by them for underwriting such a risk is lower than the internal funding costs of the originator who has a concentration of such a risk.

Players Involved In Securitization

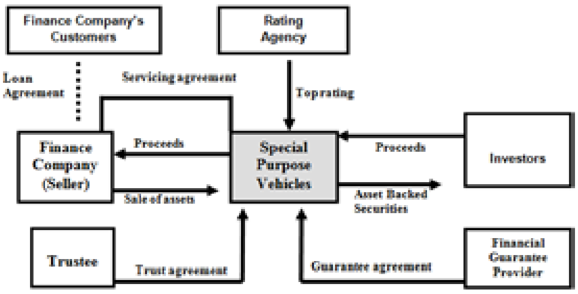

Figure-1: The primary participants involve in the issuance of asset-backed securities

Originators: Originators create the assets that are sold or used as collateral for asset-backed securities. Originators include finance companies, financial institutions, commercial banks, and insurance companies, thrift institutions and securities firms.

Servicer's: They are usually the originators or affiliates of the originators of the assets, are responsible for collecting principal and interest payments on the assets when due and for pursuing the collection of delinquent accounts. They also provide the trustee and the certificate holders with monthly and annual reports about the portfolio of assets sold or used as collateral.

Issuers: The originator does not usually sell assets to third-party investors directly as asset- backed securities. Instead, they are sold first to either a conduits or a "bankruptcy – remote" finance company. Such companies, known as limited purpose corporations, are subsidiaries or affiliates of the originator or the merchant banker that were separately incorporated to facilitate the sale of assets or to issue collateralized debt instruments. Conduits are issuers of asset-backed securities that do not originate or necessarily service the assets that underlie the securities. They buy assets from different originators or sellers, pool the assets and then sell them to investors.

Merchant Bankers: As asset-backed securities issue involves a merchant banker, who either underwrites the securities for public offering or privately places them. As an underwriter, the merchant banker purchases the securities from the issuer for resale. In a private placement, the merchant banker does not purchase the securities and resell them, rather the merchant banker acts as an agent for the issuer, matching the seller with a handful of buyers.

Credit Enhancers: Credit enhancement is a vehicle that reduces the overall credit risk of a security issue. The purpose of the credit enhancement is to improve the rating, and therefore the pricing and marketability of an asset-backed security. Most ABS are credit enhanced. Credit enhancement can be provided by the issuer or by a third party. The issuer has enhanced credit by providing recourse through senior-subordinated structure or by over-collateralization.

Rating agencies: Credit rating agencies assigns rating to ABS issues just as they do for corporate bonds. Credit rating is based on three criteria: the probability of the issuer defaulting on the obligation, the nature and provisions of the obligation and the relative position of the obligation in the event of bankruptcy.

Trustees: A Trustee in ABS is the intermediary between the servicer and the investors and between the credit enhancer and the investors. The responsibilities of the trustee include buying the assets from the issuer on behalf of the trust and issuing certificates to the investors. As the obligors make principal and interest payments on the assets, the servicer deposits the proceeds in a trust account, and the trustees passes them on the investors.

Types of Securitization: The two most common type of securitization are:

Mortgage Backed Securities: MBS are securities wherein mortgages are pooled together and undivided interests or participations in the pool are sold. The mortgage backing, a pass through security is generally of the same loan type in terms of amortization level, payment, adjustable rate etc. Moreover they are similar to with respect to maturity and loan interest rate to the extent where the cash flows can be projected as if the pool were a single mortgage. The originator services the mortgages collecting the payments and passing through the principal and interest to the security holders after deducting the servicing, guarantee and other fees

Asset Backed Securities: are securities backed by financial assets. These assets generally are receivables other than mortgage loans and may consist of credit card receivables, auto loans, manufactured housing contracts, junk bonds, equipment leases, small business loans guaranteed by some agency home equity loans etc. They differ from other kind of securities offered in the sense that their creditworthiness is derived from sources other than the paying ability of the originator of the underlying assets. They are secured by collaterals and credit is enhanced by internal structural features or external protections which ensure that obligations are met.

Securitization: A Funding Strategy in Indian contextAs we know, securitization turns into one of the villains of the global financial crisis, with lenders selling housing loans to subprime borrowers and then packaging these loans into marketable securities that were sold to investors around the world. The India's central bank (RBI) showing great concern on such type of securitization transactions initiated from specially non-banking financial companies (NBFCs).

It is been a practice of Indian NBFCs to originate loans and then immediately sell them off to other institutions or banks to make profits within a short period. This increases the risk of such transactions manifold since buyers are unable to ascertain the risk of the original investor. In its second draft guidelines announced by RBI in 2012, banks extending loans to clients should mandatorily keep them on their books for a minimum period and keep a portion of such loans, depending on their maturity. According to new norms prescribed by RBI, for loans with a maturity of two years, the originator should hold the loans for a minimum period of one year. Originating institution has to retain at least 10% of the loan portfolio in its own books, which, according to the central bank, will ensure that the project implementation risk is not passed on to investors and a minimum recovery performance is demonstrated prior to securitization to ensure better underwriting standards. Apart from above, banks are also required to carry out regular stress tests and monitor the portfolio on an ongoing basis, the central bank said.

The Growth of Securitization in India In the financial year 2012, Issuance volume in the Indian securitisation market was Indian rupees. 36,603 crores, a growth of 15% over the previous fiscal. The increase in volume—following a continuous decline for three years—was on account of a 26% rise in securitisation3 of retail loans (both Asset-Backed Securitisation or ABS, and Residential Mortgage-Backed Securitisation or RMBS, cumulatively). During financial year 2012, the securitization market in India grew by 15% over the previous year, in value terms. The number of transactions was also 32% higher in financial year 2012 than in the previous fiscal.

Trend in Structured Finance (SF) Issuances - by value, in Indian rupees crores

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	FY2009		FY2010		FY2011		FY2012	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share
Asset Backed Securities (ABS)	13,581	25%	21,497	50%	21,819	69%	26,071	71%
Residential Mortgage-Backed Securitisation (RMBS)	3,291	6%	6,254	14%	5,029	16%	7,680	21%
Total Retail Securitisation	16,872	31%	27,751	64%	26,848	84%	33,751	92%
Securitisation of individual corporate loans or loan sell-off (LSO)	35,608	66%	14,581	34%	4,441	14%	2,217	6%
Others	1,160	2%	787	2%	536	2%	635	2%
Overall total	53,640	100%	43,118	100%	31,825	100%	36,603	100%
Growth	16%		20%		(26%)		15%	

Source: ICRA RATING FEATURE May 2012

Problems with Securitization in India

In India, securitizations espouse a trust structure i.e. the assets are transferred by way of sale to a trustee, who holds it in trust for the investors. In this situation, a trust is not a legal entity in law but it is entitled to hold property that is distinct from the property of the trustee. Therefore, the trust performs the role of the special purpose vehicles (SPV). SARFAESI is quite inadequate in commercial practice. Major shortcomings of the Act are:

A security receipt (as defined in sub-clause 2 of SARFAESI Act) gives its holder a right of title in the financial asset involved in securitization. This definition holds good for structures where 'Pay through Securities' (PTCs) are issued. However, there is a lack of strong provision in case of PTC. Secondly, the legislation does not contain effective foreclosure laws. If an SPV wants to foreclose an asset owing to a default by a party, it has to resort to the traditional means of litigation, which is time consuming and expensive. The legislation also fails to define a "true sale", thereby, leaving it to the interpretation of the parties. During FY2012, the Indian income tax authorities sent notices to trustees of several securitization transactions—which the trustees in turn passed on to the investors, i.e., mutual fund houses—asking them to pay tax on income generated through pass through certificates (PTCs). Following this move, the MFs filed petitions in the Bombay HC, seeking a relief from the tax claim. The IT department's stance effectively challenges this premise and thus, a resolution to this issue could be an important factor for determining the future of securitization going forward. Most market participants are of the view that the most immediate and severe obstacle to securitization is this unresolved issue of taxation of the securitization SPV.

The secondary market in India for debt which could offer an easy exit route to investors is not yet developed. Public sector banks which have a huge pool of debts have so far remained far from these products. Trusts and Provident Funds which are the major source of huge funds, have limitations on investment in structured products. Only regulatory changes could help more funds for investment in these products.

The intermediaries involved in creating a securitized product have to comply with multiple legal provisions to give shape to the product. The financial asset is transferred from the originator to the SPV and thus attracts relevant provisions of Stamp Act, The Transfer of Property Act 1882, The Negotiable Instruments Act, and Registration Act. Moreover lack of clear supporting legal provisions for the features which are integral part of the process of securitization hinders wider acceptability of the product.

The securitization process attracts stamp duty at various stages. The incidence of stamp duty is one of the major concerns which make securitization transaction financially unviable. Typically, the rate of stamp duty ranges from 0.5 per cent to as high as 4 to 8 per cent of the value of transaction. Thus, the process of securitization becomes too expensive. Recently, there has been significant relief since Stamp duty has been reduced to 0.1 per cent in some States.

Registration requirements on transfer of mortgage backed receivables from immovable property which again adds to the cost of securitization transaction and needs to be addressed. Under the Registration Act, 1908 transfer requires compulsory registration. This also imposes additional costs to the transaction. Further some provisions of the Income Tax Act, 1961 are reported to have an impact on securitization. For instance, Section 60 of the Act, contemplates transfer of income without transfer of assets which are the source of the income. In such a case, the income so transferred is chargeable to income tax as the income of the transferor and is included in his total income. Similarly, there are other sections in the Act which restrain the progress of securitization. Another important aspect which hinders the growth of securitization in India is the lack of effective foreclosure laws. The existing foreclosure laws are not lender friendly and increase the risks of mortgage backed securities by making it difficult to transfer property in cases of default.

During the acquisition and sale of the assets of the borrower by the company, issues relating to valuation of assets and fixation of realizable value of assets have to be cleared. Value need to be arrived in transparent manner. Such values should be fairly discounted in the opinion of the values acting on behalf of the concerned bank or financial institution. The problem of making distinction between willful defaulters and others is very difficult to make. Some argue that the decision has to lie with the creditor because the misjudgment might result in a greater loss.

Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002

SARFAESI Act 2002, came into effect from June 21, 2002 and its provisions deal with Securitization along with asset reconstruction and enforcement of security interest. It facilitates asset recovery and reconstruction. The act is based upon the recommendations of the Narasimhan Committee I and II and Andhyarujina Committee Reports for enacting a new law for enacting a new law for regulation of securitization and reconstruction of financial assets, enforcement of security interest and formation of asset reconstruction companies. This would help banks and financial institutions to deal NPA in a better way with defaulters. Following three major aspects are dealt in SARFAESI:

(i) Providing a legal framework for securitization of assets; (ii) Enforcement of security interest by secured creditor (such as banks and other financial institutions); (iii) Transfer of non-performing assets to asset reconstruction companies, which can be dispose-off later and realize the proceeds.

SARFAESI has made following provisions: (a) for registration and regulation of securitization companies or reconstruction companies by India's federal bank, the Reserve Bank of India ("RBI"); (b) to facilitate securitization of financial assets of banks; (c) to empower securitization companies to raise funds by issuing security receipts to qualified institutional buyers (QIBs); (d) to empower banks and financial institutions to take possession of securities given for financial assistance and sell or lease them to take over management in the event of failure to pay.

SARFAESI Act does not permit Banks and Financial Institutions to create Special Purpose Vehicles (SPVs) for undertaking securitization transaction. The act calls for setting up of Securitization Companies or Reconstruction Companies with its registration with Reserve Bank of India (RBI) to carry on

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the business of securitization or asset reconstruction. This company can carry out the work of formulation of schemes and setup (scheme–wise) separate trusts. A Securitization company can act as an asset reconstruction company and vice versa. The act provides the reconstruction company the right to acquire financial assets of any bank by issuing debentures or bonds or any other security in the nature of the debenture. They can also acquire assets by entering into an agreement with such banks or financial institutions. The bank or financial institution gets the rights of the lender in relation to any financial asset acquired by the securitization company. Such company shall on such acquisition be deemed to be the lender and all rights of the bank or financial institution.

The securitization company cannot raise funds from retail investors. It can devise a separate scheme for each of the financial assets taken by it and raise funds only from Qualified Institutional Buyers (QIBs) by developing schemes to acquire assets. The company will issue security receipts to QIBs which represents undivided interest in such financial assets. The company will realize the financial assets and redeem the investment and will make payment to returns to QIBs under each scheme. The company should maintain separate set of accounts in respect of every such scheme for every financial asset which has been acquired by the QIB. The company should also ensure the realization of such financial assets and pay returns assured on such investments. In the case of non realization of the financial assets the QIBs of the securitization company or reconstruction company holding security receipts of not less than 75% of the total value of the company is entitled to call a meeting of all the QIBs and every resolution passed in such meeting should be binding on the company. Any dispute between QIBs and the company shall be referred for conciliation or arbitration under the Arbitration and Conciliation Act 1996.

Conclusion

In today's environment, study of securitization is of great importance because of the opportunities it offers as a source of financing. Therefore it is considered that securitization is another venue for financial institutions to demonstrate their competitiveness and to broaden their markets. Not only in US & Europe but also in other parts of world, securitization has emerged as one of the most effective means of capital creation. India is not far behind though it is in its early stage in India because of the large benefits it holds for banks and financial institutions the concept has picked up. While securitization can be a means to manage balance sheet risks and operational risk by banks and financial institutions it should be emphasized that banks and financial institutions should not consider it as a means to get rid of their obligations. Securitization has in particularly proved to be a boon to fund starved infrastructure projects. While more complex securitization transactions and public issuance of securitized papers are a far dream, clear legislation and investor education can prove to be a catalyst for Indian securitization market. Securitization as a financial instrument has been prevalent in India since 1990s. It has been a tremendous boon for banks/ financial institutions which are beleaguered by excess illiquid and non-performing assets. However, laws governing such transactions, which were introduced later, although tried to regulate securitization but left much to be desired owing to ambiguity and shortcomings. Hopefully, the gaps will be plugged and the necessary steps will be taken soon to alleviate all concerns.

The SARFAESI Act 2002 is an important step by Indian government as it provides the much needed legal sanctity to securitization by recognizing the securitization instrument as a security under the SCR Act. Development of the market for securitization in India will need efforts of the Central Government, State Governments, Reserve Bank of India and Security Exchange Board of India (SEBI) has permitted mutual funds to invest in these securities. To galvanize the market Foreign Institutional Investors (FIIs) can also be allowed to invest in securitized debt within certain. FIIs are already familiar with these instruments in other markets and can, therefore be expected to help in the development of this market. However the government and regulatory authorities in India should realize that the measures taken up by them are incomplete and more dedicated efforts are necessary for a robust growth of asset securitization market in India.

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