Chapter 6 – Securitization

Concept of Securitization

The process of securitization typically involves the creation of pool of assets from the illiquid financial assets, such as receivables or loans which are marketable. In other words, it is the process of repackaging or rebundling of illiquid assets into marketable securities. These assets can be automobile loans, credit card receivables, residential mortgages or any other form of future receivables.

Features of Securitization

- **Creation of Financial Instruments -** Additional financial instruments by way of new securities are created which are backed by collaterals.
- **Bundling and Unbundling -** When the mortgaged based assets are combined into a pool on the basis of same rate of interest and maturity period by the originator, it is bundling and when these are broken into instruments of fixed denomination by the SPV, it is unbundling.
- **Tool of Risk Management -** In case of assets are securitized on non-recourse basis, then securitization process acts as risk management as the risk of default is shifted from the originator.

Features of Securitization

- **Structured Finance -** The process of securitization is a structured finance as the financial instruments are tailor made to meet the risk return trade profile of the investors.
- **Securities are divided into tranches -** Portfolio of different receivables or loans are divided into several parts based on risk and return which are called tranches.
- **Homogeneity -** Under each tranche, the securities issued are of homogenous or similar nature and even meant for small investors who can afford to invest in small amounts.

Benefits of Securitization

From the angle of originator

- **Off – Balance Sheet Financing -** When loan/receivables are securitized, funds are raised without increasing the liability side of the balance sheet of the company. Financial assets i.e. illiquid mortgaged based assets are sold to SPVs and in their place, liquid assets in the form of cash is received from the SPVs.
- **More specialization in main business -** By transferring the assets, the entity could concentrate more on its core business as servicing of loan is transferred to SPV.

Benefits of Securitization

From the angle of originator

- **Helps to improve financial ratios -** It helps to improve the Capital – to - Weighted Asset Ratio effectively in case of Financial Institutions and Banks. The reason is that by transferring the illiquid and risky assets to SPVs, the risk weighted assets are reduced.
- **Reduce borrowing Cost –** Since securitized papers are credit rated due to credit enhancement they can be issued at lower rate of interest as the originator earns a spread, resulting in reduced cost of borrowings.

Benefits of Securitization

From the angle of investor

- **Diversification of Risk -** Purchase of securities backed by different types of assets provides the diversification of portfolio resulting in reduction of risk.
- **Regulatory requirement -** Acquisition of asset backed belonging to a particular industry say micro industry helps banks to meet regulatory requirement of investment of fund in industry specific.
- **Protection against default -** In case of recourse arrangement, if there is any default by the borrowers (obligors), then the originator shall make good the default.

Participants in Securitization

Primary Participants

- **Originator –** It is basically the initiator of the securitization process. It sell the illiquid assets lying in its books to the special purpose vehicle.
- **Special Purpose Vehicle (SPV)** – After purchasing the illiquid assets from the originator, the SPV makes an upfront payment to it. Then, it converts those illiquid assets into marketable securities and issue it to the investors.

Participants in Securitization

Primary Participants

- **The Investors -** Investors are the buyers of securitized papers which may be an individual, an institutional investor such as mutual funds, provident funds, insurance companies, mutual funds, Financial Institutions etc.

Participants in Securitization

Secondary Participants

- **Obligors -** They are the parties who owe money to the originators. The amount due from the obligors is transferred to SPV which in turn passes it on to the investors of securitized instruments.
- **Rating Agency -** Since the securitization is based on the pools of assets rather than the originators, the assets have to be assessed in terms of its credit quality and credit support available. Credit Rating Agencies provide that.
- **Receiving and Paying agent (RPA) -** Also, called Servicer or Administrator, it collects the payment due from obligor(s) and passes it to SPV.

Participants in Securitization

Secondary Participants

- **Agent or Trustee -** Trustees are appointed to oversee that all parties to the deal perform in the true spirit of the terms of agreement. Normally, it takes care of interest of investors who acquires the securities.
- **Credit Enhancer –** It provides additional comfort to the investors to whom the securitized instruments are issued in the form of additional collateral or third party guarantee such as letter of credit or surety bond.

Participants in Securitization

Secondary Participants

- **Structurer -** It brings together the originator, investors, credit enhancers and other parties to the deal of securitization. Normally, these are investment bankers i.e. merchant bankers also called arranger of the deal. It ensures that the deal meets all legal, regulatory, accounting and tax laws requirements.

Mechanism of Securitization

- **Creation of Pool of Assets -** The process of securitization begins with creation of pool of assets by separation of assets backed by similar type of mortgages in terms of interest rate, risk and maturity.
- **Transfer to SPV -** Once assets have been pooled, they are transferred to Special Purpose Vehicle (SPV) especially created for this purpose.
- **Sale of Securitized Papers -** SPV designs the securitized instruments on the basis of nature of interest, risk, tenure etc. by converting them into marketable securities and issue them to the investors. The investors are then given Pass Through Certificate or Pay Through Security.

Mechanism of Securitization

- **Administration of assets -** The administration of assets then passes back to originator which collects principal and interest from the underlying assets and transfer it to SPV, which works as a conduit or channel.
- **Recourse to Originator –** In case of default in payment by the borrowers (obligors), the liability to pay transfers to the originator from the SPV.
- **Repayment of funds –** The SPV repays the invested amount to the investors in the form of interest and principal that arises from the assets pooled.
- **Credit Rating to Instruments -** Sometimes before the sale of securitized instruments, credit rating can be done to assess the risk of the issuer.

Problems in Securitization

- **Stamp Duty -** Stamp Duty is one of the major obstacles in India. Under Transfer of Property Act, 1882, a mortgage debt stamp duty may goes upto 12% in some states of India and this impedes the growth of securitization in India.
- **Taxation -** Taxation is another area of concern in India. In the absence of any specific provision relating to securitized instruments in Income Tax Act, experts' opinion differ a lot. Differences of opinion exists as to whether SPV as a trustee is liable to be taxed in a representative capacity or not.

Problems in Securitization

- **Accounting –** Confusion exist in accounting aspects also. Transfer of mortgaged assets to SPV is an off balance sheet transaction in which the receivables are removed from the balance sheet of the originator. But, originator is still responsible for collecting the interest and principal amount from the obligors and transfer it to the SPVs. For this purpose, the experts say that the originator has to maintain accounting entries. Again, lack of clarity is there when the securitization is on non-recourse basis.

Problems in Securitization

- **Lack of standardization -** Every originator follows his own procedure for documentation and administration of the securitization process. So, having lack of standardization is another obstacle in the growth of securitization.
- **Inadequate Debt Market -** Lack of existence of a well-developed debt market in India is another obstacle that hinders the growth of secondary market of securitized or asset backed securities.
- **Ineffective Foreclosure laws –** Since Foreclosure laws are not supportive to lending institutions, this makes securitized instruments less attractive as lenders face difficulty in transfer of property if borrowers default.

Securitization Instruments

- **Pass Through Certificates (PTCs) –** This is a certificate given to the investors of securitized instruments that interest and principal amount will be paid to them. They are called PTCs because the interest and the principal amount is passed through from the borrowers to originators, then to SPVs, and finally to the investors.
- **Pay Through Security (PTS) –** In this case, SPV issues new securities to the investors in place of a pass through certificate. These securities are generally considered safe securities from which interest and payment of the principal amount is almost assured.

Securitization Instruments

Stripped Securities - Stripped Securities are created by dividing the cash flows associated with underlying securities into two or more new securities such as:

(i) Interest Only (IO) Securities

(ii) Principle Only (PO) Securities

These are generally considered as volatile and less preferred by the investors.

Pricing of the Securitized Instruments

From Originator's Angle

From originator's point of view, the instruments can be priced at a rate at which originator has to incur an outflow and if that outflow can be amortized over a period of time by investing the amount raised through securitization.

From Investor's Angle

From an investor's angle security price can be determined by discounting best estimate of expected future cash flows using rate of yield to maturity of a security of comparable security with respect to credit quality and average life of the securities.

Securitization in India

It is the Citi Bank who pioneered the concept of securitization in India by bundling of auto loans into securitized instruments. Thereafter many organizations securitized their receivables. Although started with securitization of auto loans it moved to other types of receivables such as sales tax deferrals, aircraft receivable etc.

The important highlight of the scenario of securitization in Indian Market is that it is dominated by a few players e.g. ICICI Bank, HDFC Bank, NHB etc. Moreover, from 2019-20 onwards, the securitization volume has picked up in India.

Securitization in India

Furthermore, the liquidity need for NBFCs on a continuous basis coupled with the growing inclination of investors toward securitized instruments bodes well for the future of securitization in India. Also, the developments on the regulatory front also likely to provide a fillip to the securitization in the near future.

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THANK YOU