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An Insight into the Conceptual Framework of Securitization

AN INSIGHT INTO THE CONCEPTUAL FRAMEWORK OF SECURITIZATION

by
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ABSTRACT

Securitization as a process is a kind of financial arrangement and a form of financial innovation which has significant implications on financial markets of an economy. Securitization is a process to convert illiquid assets or non-marketable assets into liquid assets and tradable securities; thereby reducing the risk of an asset becoming a non-performing asset. It would not be appropriate to comment on the concept of securitization as being good or bad because it has its own advantages, disadvantages, costs and benefits that follow. Although the opinions/views of researchers and scholars are polarized on the assessment of success of securitization market and many feel that even the securitization market undoubtedly played a role in the Global Financial Crisis (GFC)[1]*, it is also pertinent to point out, however, that this was not autochthonous to all securitization markets.*

The need for securitization in India has existed in three major areas - Mortgage Backed Securities (MBS), the Infrastructure Sector and other Asset Backed Securities (ABS).The need arose due to the significant impact of introduction of financial sector reforms in India which led to innovations in financial markets and instruments. The Financial Institutions/banks have made considerable progress and

have been taking efforts to finance large scale projects especially in the housing and infrastructure sector. It is therefore necessary that securitization and other similar financial arrangements get developed so that Financial Institutions/Banks can unship their exposure and can finance new projects. A number of legal, regulatory, psychological and other issues need to be delved into before we can promote the growth of securitization in India. It requires a subjective evaluation of particular securitized asset class to comment on the success or failure of the securitization market. But before evaluation of the market as such it is imperative to understand holistically the mechanism of the process itself before delving into the intricacies of the same. This research paper is an analytical work of the author on the mechanism behind the securitization process so as to recount for the costs and benefits attached with the process as such. This paper seeks to present a comprehensive outlay of the process for its readers and to delineate the significance of the process in financial markets.

Keywords: Securitization, Banks, Mortgages, Financial Instruments; Rating; Rating Agencies; Regulation, Non-Performing Assets."

I. INTRODUCTION

Securitization as a concept first evolved in the year 1970, when Government National Mortgage Association (GNMA)[2] securitized the U.S. government-guaranteed residential home mortgages. During the 1980s the market for Securitization emerged for residential mortgage-backed securities (RMBS) in the United Kingdom and Asset-

Backed securities (ABS) in

the United States. The year 1990s marked further development and growth in the ABS and Mortgage-Backed Securities (MBS) markets in continental Europe, the United Kingdom as well as the United States' Real Estate Sector.[3] It would be delusive to discuss the market for securitization as a single, homogenous asset class as the market has performed varyingly before, after and during the GFC.[4]

The introduction of financial sector reforms in India has led to innovations in financial markets and instruments. Increased pressure on efficiency of operation, on market nooks, on advantages of market creation and competition and on capital strength, all factors have worked as fuel for the changes and advancements in the dealings related to financial markets. Securitization is one of the solutions to these challenges. It would not be appropriate to comment on the concept of securitization as being good or bad because it has its own advantages, disadvantages, costs and benefits that follow. With the introduction of financial sector reforms in the early nineties, various Financial Institutions/banks, particularly the Non-Banking Financial Companies (NBFCs), have created and generating and large volumes of homogeneous classes of assets (such as auto loans, credit cards). This has led to attempts being made by a few players to get into the ABS market as well. However, still a number of legal, regulatory, psychological and other issues need to be sorted out to facilitate the growth of securitization in India. It requires a subjective evaluation of particular securitized asset class to comment on the success or failure of the securitization market.

II. SECURITISATION: THE EXPLICATION

The process, by which tradable capital market instruments are created, is securitization and it essentially implies creation of securities. In general parlance, in this process there is repackaging of assets done with the purpose of refinancing. In the process similar kind of loans and receivables are packaged. It is a process wherein the pools of individual loans or receivables (i.e. the assets) shall be re-packaged, underwritten and distributed to investors in the form of securities. These securities are collateralized by the assets themselves and/or the cash flows arising there from, which represent the primary source of repayment of investor[5].

In the Indian scenario, it is the process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that would

be sold to the investors[6]. Under the *Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002*(hereinafter referred to as SARFESI), the process of securitization is documented wherein there is a transfer of funds from the originator to the Securitization Company and the same is issued to the investors representing undivided interest in the security receipts[7]. Thus the generic meaning of securitization is the process wherein all kinds of financial claims are transformed into marketable/tradable securities to ensure liquidity and in which cash flows or claims against third parties either present or future, are firstly identified, then consolidated after separating it from the originating entity, and then divided or fragmented into "securities" to be offered to investors. Thus on the basis of the above generic definition, it can be observed that:"

- Securitization is the process of commoditization: As it has been seen, securitization is a process to bring forth instruments that can be traded in the market.
- Securitization is the process of integration and differentiation: The securitization company, which can act in the capacity of Special Purpose Vehicle (hereinafter referred to as SPV) pools the assets together, which may be referred to as the process of integration. This pool is broken down into instruments of fixed denominations as securities that are given to the Qualified Institutional Buyers (QIB), which may be referred to as the process of differentiation.
- Securitization is the process of anatomization of an entity: Securitization splits the portfolio into different subsets so as to suit the needs of different investors like Junkies who would want more return and ready to take more risk and the Conservative investors who want minimal return but safer investment and do not want high risk investments. The cash flow thus goes into different classified heads with differential returns

Securitization is a process by which assets are sold to an SPV or an independent entity and the Originator here receives the immediate cash payment from this SPV. Thus there is 'Bankruptcy remoteness in the SPV' and balance sheet of the Originator remains clean of any NPAs (Non-Performing Assets). The cash received from the pool of assets helps in servicing the securities. Securitization is essentially a two-stage process.[8]

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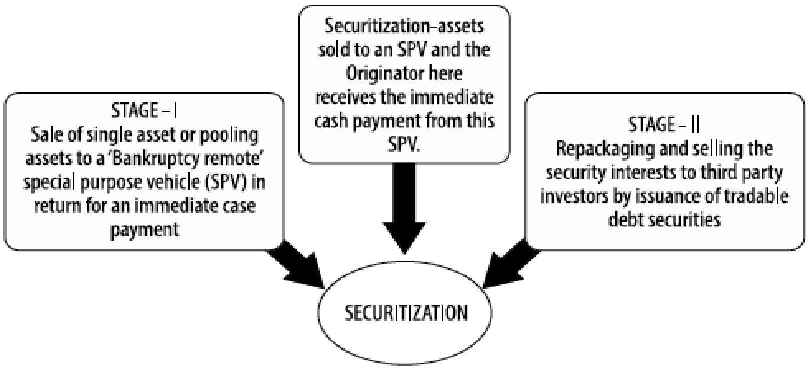

- Securitization is a kind of structured finance;[9]
- It involves pooling and re-packaging of similar/homogenous loans which are otherwise illiquid into marketable and tradable securities.[10]
- It allows the investor to sell or assign its interest or stake in a pool of assets or the underlying securities to other entities.

III. SECURITIZATION: THE ESSENTIAL FEATURES

Herein, it is to be noted that the transfer of securities does not mean secured instrument. For the purposes of securitization, the word *security* and *security receipt* means a financial claim that is manifested in the form of document, which is one of the essential parameters of marketability. For an asset to be marketable there should be a general acceptance and agreement as to the fact that the instrument is of value and worth. Two ways to increase the investors faith on the investment or the instrument is to secure it by creating charge over the assets or by getting the credit rating done by some renowned credit rating agencies (CRA). To enhance the liquidity of the instrument; the assets are generally pooled in homogenous/similar lots[11]. The essential features of Securitization are:

i. *Marketability*: The very question of effectiveness of the securitization process lies in the fact that it ensures liquidity and marketability

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of financial claims. Hence, the instrument is structured in such a way that its marketability and increases by making it appear a healthy and profitable investment for the investors. Two important postulates are to be kept in mind so that it can be marketable:

- The legal postulate to market the instrument: With the in vogue of SARFESI, there is a legal mechanism wherein the main postulates of Securitization has been explained as:
  1. Acquisition of financial assets from the originator;
  2. Sale of the acquired assets to qualified institutional buyers; and
  3. Issue of security receipts.
- Existence of the Market for the Instrument: The whole purpose of securitization would be defeated if there is no market in which they can be traded. The same is ensured by introducing it in the stock market or other exchanges or other market players for the issuance of security receipts. Under the Indian scenario, the same is ensured by issuance to the QIB.
  i. *Merchantable Quality:* It should be ensured that the security receipts issued to the investors are of tradable quality. The same is to be ensured to the investor's satisfaction and the same is ensured by the rating agencies. Rating Agencies are a *sine qua non* for the securitization process that can be properly indicate the risk inherent in the security receipts[12].
  ii. *Homogeneity:* The essential feature that it may serve as a market instrument is that it can be packaged into homogenous lots.

For example: Home loans together, Car loans together respectively in different pools.

IV. STRUCTURE OF SECURITIZATION

The process of securitization helps the investors to earn money and get assured returns. The process helps the investors to own securities which represent ownership of collateralized pool of assets (generally secured by personal or real property (e.g. automobiles, real estate, or equipment loans) and in some cases are unsecured (e.g. credit card debt, consumer loans) that helps them to procure additional securities or interest payments and many times investors benefit from fixed income that they derive from these securities. This process ensures swathing of investors from risk of Bankruptcy of the Originator (Seller). This is done by passing on this risk to another

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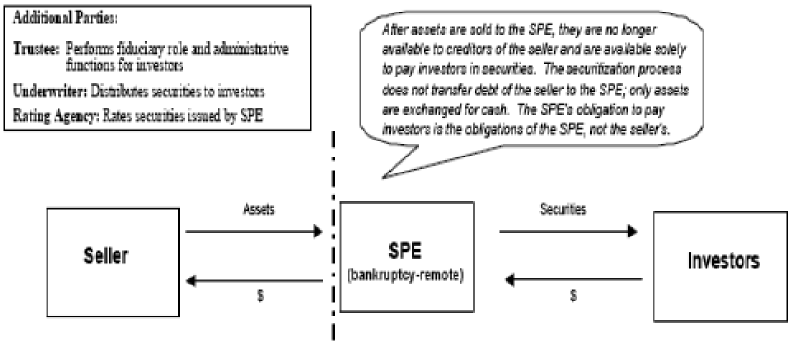
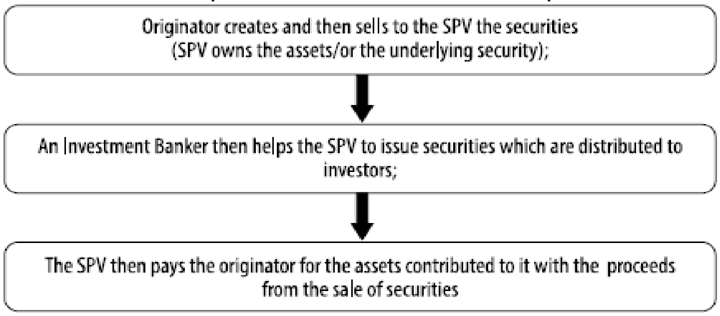
independent entity in the form of SPV than letting it to feature on the balance sheet of the Originator. By this the intended “Bankruptcy remoteness” is achieved. Investors also feel secured because the pool of assets is held by the SPV and is not subject to any subsequent slump in the financial condition or credit worthiness of the Originator.

The basic Securitization Structure is depicted as under[13]. Figure below:

Basic Securitization Structure



Order of steps in a securitization process[14]:



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QUINTESSENCE OF SECURITIZATION[15]:	PURPOSE
• This new SPV has limited purpose and defined activities.	• Off-Balance sheet • "*Bankruptcy Remoteness*" • Reduction of credit risk
• There is true legal sale of assets to the SPV	• Administration of the assets by SPV, including continuation of relationships with obligors.
• The investors rely on the performance of the underlying assets for repayment than the '*Originator*' (the Seller) or the '*Issuer*' (the SPV)	Support for timely interest and principal repayments in the form of suitable credit enhancements. • Ancillary facilities to cover interest rate / forex risks, guarantee, etc. • Formal rating from one or more rating agencies.

There is generic differentiation between the structure of securitization that is envisioned in the SARFESI and other popular modes of securitization that is *pay through* mechanism and *pass through* mechanism.

a) *Pass through Mechanism:* Under this structure, the SPV issues certificates which give the right of participation to the investors in the form of 'participation certificates' that ensures that the investors directly get the payment of interest and can participate directly in the market and fathom the performance of the securitized assets.

b) *Pay through Mechanism:* Under this structure, the investors do not get the interest payment directly rather they get new securities in lieu of the interests. In this the SPV is the one that actually owns the securitized assets and the investors only get a charge against the securitized assets. The SPV is at liberty to deal with the assets as per its discretion.

c) *Under the SARFESI:* Owing to the process as has been envisioned under the SARFESI, the aspect that in the process of securitization, security receipts are issued to QIB representing undivided interest in the same. Hence in the Indian scenario, it has been said that *pay through* structure is not possible and the QIBs have better right than that in *pass through* scheme. Although it has been observed that most securitization in India adopts a trust like structure — with

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the underlying assets being transferred by way of a sale to a trustee, who holds it in trust[16].

Figure 1: The Structures of Securitization

V. ADVANTAGES OF SECURITIZATION

Securitization thus is the process of issuing securities which may or may not be traded. The security is issued by converting the 'financial asset' into liquid securities. The investors in the market place are increasing in number and correspondingly, the space per investor in the market is on the diminishing scale. The small investors are benefitted because they get a liquid instrument that is easier to understand which is otherwise complicate for them not being well equipped with the knowledge of investments. The benefits of securitization would differ as per the legal regime of securitization of various countries[17], but the advantages of the process are highlighted are:

- *Balance Sheet Efficiency:* The receivables and assets to be securitized are removed from the balance sheet of the originators and the same is repaid to them by the sale proceeds of the securities to the QIB by SPV. Hence the same process leads to balance sheet efficiency as assets are removed by an equivalent cash requirement, which is the need purpose of the process. The originator can issue

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the Asset backed Securities without the *recourse provision* which would reduce its risk on the default of the borrower. Once such deal concludes, the Originator can book its profit after applying the *accounting principles* i.e. revenue recognition and revenue accounting that is done on an accrual basis[18].

- *Credit Exposure:* The originators can diversify the portfolio and reduces the risk associated with the credit and the risk entailed would only be limited to any kind of credit enhancement that the originator might be offering.

- *Asset Liability Matching:* The effectiveness of the securitized transactions lies in asset-liability management principle. It has to be ensured that there is periodic and continuous flow of payments from the original investor (loan taker) in time to match with the liability of timely paying the securities holders in securitized company.
- *Higher Returns to the Investors:* The investors would invest in securities that give them the maximum yield. Thus the investor would invest in security receipts if it is found that there are better returns in the securitization agreement than in other securities. Herein there are credit agencies that help the investors make a consolidated choice and hence they invest after they are satisfied that it would produce better yields.
- *Safety:* The investors would invest in securities that would give them yield over a sustained period of time. Herein, the credit rating agencies like CRISIL gives rating (AAA or AA etc.), which would give the investor of assurance of higher pedigree of safety attached with such instruments.

VI. DISADVANTAGES OF SECURITIZATION[19]

- *Complicated to structure the finance*: How to execute and structure the financing in securitization is a major concern. Because this is a highly complex structure to execute it properly and still offer the diverse portfolio to the investors according to their needs and suit their expectations from an investment is quite an arduous task.
- *Threat of pre-payment:* In securitization one of the major threats is of the pre-payment by the loan taker. If the person pays then the return to the investors in the securitization company gets reduced as now there is no flow of interest payment from the loan taker or the original investor. So if the investors think that they will not lose

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money in these kind of investments still there is a threat of reduced returns.

VII. THE CONCEPT OF TRANCHES AND CREDIT ENHANCEMENT IN SECURITIZATION

The literal meaning of tranche which is actually a French word is “portion” or “slice”. In securitisation the concept assumes cardinal importance as this may help to attract investors by offering them flexibility in their investment. This also improves the marketability of the security offered by the issuer or the SPV.MBS most often exhibits the tranches. Tranches mean division of securities in such a way so as to suit the needs of the investor according to their preferences and flexibility with maturity as well.[20]

For example, there are two investors “A” and “B”. While A requires immediate cash flow and has no desire to make money from the investment in securities in the longer run; B might be an investor not interested in immediate cash flow but good return from the investment in the longer run. So thus the SPV can split the security in tranches depending upon maturity and cash flow so as to suit the preference of the investor. Also tranches may even be created on the basis of percentage of losses subsumed by an investor on the basis of whether an investor is a conservative investor worried about the percentage of return on the investment and risk associated with the investment as they have less money to invest, rather to say they cannot afford to lose the little money that they invest while there are other class of investors who are accredited investors and may afford to take high risk as they are basically speculators and may be termed as "Junkies" who invest in Junkie Bonds so as to get high return. They subsume greater loss than conservative investors if the SPV is at loss and get most high percentage of return if the SPV's cash flow is good. They take more risks than the conservative investors in expectation of high percentage of return. The tranche may be categorized into Senior Tranche (less profitable, less risky, safer investments, usually with AAA rating), Medium Tranche and Junior Tranche (most profitable but very risky if loss occurs usually with BBB rating).Whether a tranche or a particular asset under securitisation has a stable outlook or not would depend upon the Credit Rating of the company or the SPV in respect to those securities or assets.

Sometimes to make securitization process more attractive the SPV might also offer insurance policies to investors, third-party guarantee to cover the risk in the investment and to provide assurance of the fact that the issuer or the SPV will honour the obligation which in turn improves the

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credit worthiness of the SPV thereby helping it to achieve more stable outlook and high or good credit rating. This is called Credit Enhancement in securitization.

VIII. CONCLUSION

Securitization is an innovative financing having more positive influence on the financial markets which is quite evident from the traction and vogue that it has received form the investors an and the issuers.

With the advent of the Basel II Norms, which are to be implemented by all banks in India having an International presence by March 2008, and the consequent strain on capital that banks will face, securitization will undoubtedly play a major role in the years to come. It is already fast picking up in a country like India, following the U.S example, where beginning from housing loans, securitization spread like wild fire to other areas including credit card receivables, auto loans, air ticket sales and even bundling existing securities into new securities, called collateralized debt obligations.

However, what has to be kept in mind is that these instruments can often be very complex in nature and their true nature might not be understood properly. This could lead to problems, as a risky asset might be rated highly, catching the interest of the investors, only to find that they have been caught up in a mess. The recent sub-prime loan crisis in the U.S. is evidence of such a problem having large scale repercussions, not just on the loan industry, but the entire economy of a country.

In such a situation it becomes imperative on 'Rating Agencies' to provide a proper rating for these complex instruments. Complex securitized instruments have in recent times continued to receive favorable ratings despite the apparent decline in lending standards and slowing of the housing market. The problem is that whenever there is a new product, as in the case of collateralized debt obligations (CDOs) and other asset-backed commercial paper (ABCP), etc., there will always be a long lead time before the rating agency is able to collect the required historical data that is crucial to its pricing. As financial innovation continues there is always going to be a new risk that catches rating agencies unawares, simply because no one has ever seen its like before. This is exactly what happened in the sub-prime crisis, no one had ever envisaged that liquidity could dry up like this and so abruptly. Thus, not only do rating agencies have a responsibility to fulfill, investors too have to be careful while considering the kind of instruments they are going in for, and ensure that they carry out a thorough research and understanding of the product they are investing in and understand the liabilities attached with it.

The role of RBI is commendable in developing the securitization market in India. The RBI not only strictly executes and implements the Priority Sector Lending (PSL) norms but also monitors (on a periodic basis than annual basis) the compliance with the same.

It has also contributed by providing clarity on dealing with the market by issuing two guidelines:[21]

- "*The Guidelines on Securitisation of Standard Assets issued dated 1 February 2006.*"
- "*The Guidelines on Securitisation Transactions dated 7 May 2012 and 21 August 2012 (as applicable to all scheduled commercial banks, all India term-lending and refinancing institutions and non-banking financial companies)*."

As we have seen that Securitization has become an essential ingredient of the financial market and the process has been initiated to improve the credit worthiness of the banks and the financial institutions as the banks have to maintain a particular amount of reserve with the RBI for loans and hence bad debts or non-performing assets increase the liability on the banks.

IX. RECOMMENDATIONS AND SUGGESTIONS

Securitization helps an economy by stimulating flow of credit and by transforming illiquid assets into easy convertible marketable and tradable securities. It is not only helpful for the banks or Originators which use securitization mainly for the purpose keeping their balance sheets clean because of the NPAs but also for the investors who get to diversify risk.[22] But again there are risks and disadvantages attached with securitization market which must not be ignored. Market participants and investors must apply due diligence methods to know the right investment and not blindly place too much reliance on the assessment reports of the Credit Rating Agencies (CRAs). Also the continuous monitoring and supervision right from the stage of loan origination to securitization must be done so as to see to that the loan lending practices and regulation do not deteriorate in standards. Also dynamic regulatory reforms which are necessary to provide more clarity on the process should be introduced with objectivity and within reasonable time frame so as to curb the issues arising out of uncertainty in regulatory framework.

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[1] "*The financial crisis of 2007-2008, also known as the global financial crisis considered by many economists to have been the worst financial crisis since the Great Depression of the 1930s. The housing market in the United States suffered greatly as many home owners who had taken out sub-prime loans found they were unable to meet their mortgage repayments, the borrowers found themselves with negative equity. With a large number of borrowers defaulting on loans, banks were faced with a situation where the repossessed house and land was worth less on market than the bank had loaned out originally. The banks had a liquidity crisis on their hands (the credit crunch)..*"

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