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Revisiting A Panicked Securitization Market

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Abstract: *With the passage of Finance Bill 2013 on April 30 in Lok Sabha proposing to Levy a 30% distribution tax on the investors in securitization deals through special purpose vehicles, there is a stir in the securitization market. The principal investors (banks) were paying the tax on their net income from the securitization transaction through SPVs. Now, they will be taxed on the gross income as per the new Finance Bill. The new securitization guidelines issued in May 2012 dipped the volume of fresh issue to Rs. 28,400 crore from Rs. 44,500 crore in the preceding fiscal.*
***Keywords**:Securitization, Financial Markets, Banks, Non-banking Finance Companies, Securitized instruments.*

I. Introduction:

The primary function of financial intermediaries like banks, financial institutions and non-banking financial companies (NBFCs) is that of a conduit between the users and suppliers of funds. The process of economic liberalization in general, and the phased dismantling of interest rate controls in particular, have opened new vistas for the growth of financial services sector. Increased competition and the burgeoning requirements of a fast growing economy intensify the pressure to innovate, to offer such products that channelize the flow of funds from investor to user in a more efficient manner.

The historical role of financial intermediaries of collecting deposits and lending them to funds seekers has been supplemented and, to some extent, even replaced by Securitization processes. A securitization process bypasses traditional intermediaries and link borrowers directly to money and capital markets or link the savers with borrowers.

Securitization refers to the conversion of cash flows into marketable securities. It is a process through which illiquid assets are packaged, converted into tradable securities and sold to third party investors. Securitization allows the lender to sell his right to receive the future payment from the borrowers to a third party and receive consideration for the same much ahead of the maturity of loan. It needs not to be confined to lender borrower relationships. It can be applied to supplier-buyer relationships. Manufactures or sellers supplying goods to their high quality customers on installment basis, can raise funds by securitizing these installments. If the customers are of high quality, it is possible to have a high rating for securitized paper leading to interest cost saving. Thus, this may be cheaper than traditional source of funding like bank finance.

Securitization defined:

Securitization in a broader sense indicates the process of disintermediation where in the borrowers bye-pass the traditional intermediation process by accessing the investor community directly in the money and capital markets through issuing their own securities. Securitization as an innovation in the financial market covers the process of converting the contractual debt into tangible securities and selling them to end investors after properly packaging and underwriting the same. Few of the definitions are given below: -

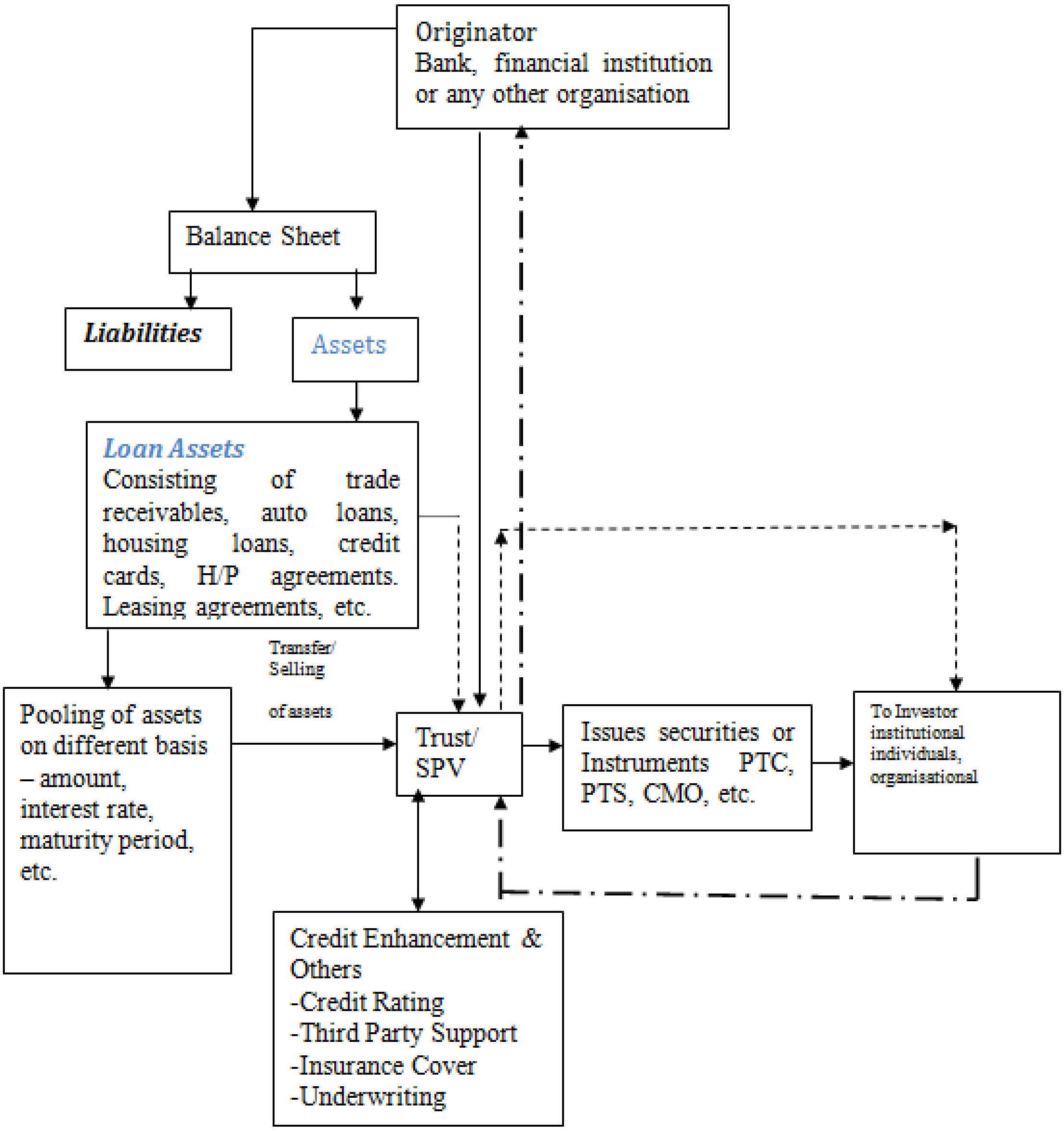
1. "Securitization is the issuance of marketable securities backed not by the expected capacity to repay of a private corporation or public sector entity, but by the expected cash flows from specific assets."
2. " "Securitization is essentially a sophisticated form of factoring or discounting of debts. It is a process where an owner of receivables (the originator or seller) sells off its receivables to a third party (the purchaser or special purpose vehicle or SPV), in return for a purchase price payable immediately on sale."

Process:

Securitization is the most prominent gadget of finance. To understand it, its process is necessarily to be followed which can be illustrated as below-

Let us take the example of a bank or a financial institution. The assets of a bank can broadly be classified into investment assets and loan assets. The investment assets are tradable and transferable. They are easily convertible into cash. Therefore, they have advantage of liquidity and adequate liquidity is the hallmark of healthy banking and its balance sheet. On the other hand, loan assets are the loans given to individuals, small businesses and corporate. These assets are non-tradable and non-transferable. They are not easily convertible into cash. Therefore, there is disadvantage of liquidity. Here lies the problem of making loan portfolio of a bank liquid. Someone got the clever idea of transforming loans into securities in order to acquire the characteristics of marketability - having buyers for loans turned into securities. This is how it came to be known as Securitization. Following diagram is worth noting –

Following diagram will help in explaining the process of Securitization



SPV or Trust realizes the interest on loans & principal on maturities & paying to investors regularly.

Securitization Process

Dig

— · — · Proceeds realized from investors being paid to Originator by SPV/Trust

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1.Origination: A borrower approaches a bank/finance company/housing finance company for a loan. The company evaluates credit worthiness of the borrower and signs a contract structuring payments over a life of loan. This loan becomes an illiquid asset of the company. The number of such assets gets swelled with the passage of time causing the problem of liquidity to the company to carryout its operations. Company decides about Securitization. Company shall be known as originator.

2.Pooling of Assets: Similar loans or receivables are clubbed together to create an underlying pool of assets. The similarity is based on the amount of loan, tenure or interest rate. Typically, this pool of assets is transferred in favour of SPV, which acts as trustee for the investors. Once the assets are transferred, they are no longer held in the originator's portfolio.

3.Splitting up in Marketable lot: The spirit of Securitization needs splitting up of portfolio into marketable lots. Securities are created out of SPV for investors. The securities are in the form of certificates (Bond or Promissory Notes) called PTC (Pass Through Certificates). It indicates maturity period which synchoronises with maturity of portfolio securitized. These securities are normally without recourse to the originator. Thus, investor can hold only SPV liable for principal repayment and interest recovery.

4.Enhancing Creditability: To increase marketability of the securitized asset in the form of certificates, these may be rated by some reported Credit Rating Agency. Credit rating increases the trading potentials of the certificates and thus, its liquidity is enhanced. Such securities are also credit enhanced through a Letter of Credit or even insurance so that investors considering these safe are tempted to invest in such securities.

5. Sale to Investors: The issuers assume the responsibility of making a market in the newly created securities for the convenience of the investors. They sell the PTCs to investors. To assure liquidity to investors, PTCs can be traded in secondary market once these are listed in stock exchange.

6.Final Settlement: Once the end investor gets hold of these instruments created out of Securitization he is to hold it for a specific maturity period which is well defined with all other related terms and conditions. Of course, they can trade these instruments in the secondary market. The maturity period for end investor is designed by taking into consideration the period of recovery from the borrowers by originator and passing of proceed of SPV. On maturity the end investor gets redemption amount from the issuer along with interest due on the amount.

The above mentioned process can also be discussed in three functions such as the origination function the pooling function and the Securitization function. Following points are worth mentioning here: -

- Generally, the investors base for such securities is largely institutional consisting of provident funds, pension funds, insurance companies, charitable and other trusts.
- The underlying assets can be serviced either by a third party or by the originator itself.
- The spread available between the yield from the secured assets and the interest paid to the investors is retained by the originator.
- A basic feature of the Securitization process is the issue of security without recourse to the issuer. There is no guarantee to the investors other than the cash collateral which is kept separate with the trustee/SPV. Thus, the issuer is under an obligation to pay the investors only if the cash flows materialize from the receivables. If the cash realized is less than the payment to be made, the loss is shared pro-rata by investors.

In case of difficult debt the issuer may, however initiate legal action and subsequent recoveries may be distributed amongst the investors on pro-rata basis after deducting the expenses.

It is obvious that non-recourse nature of the transaction means investors bear the credit risk i.e., the risk of default. No doubt, the pooling of assets lowers this risk but it can be reduced even through credit enhancement facilities such as credit rating, insurance, letters of credit or guarantee.

With the passage of Finance Bill 2013 on April 30 in Lok Sabha proposing to Levy a 30% distribution tax on the investors in securitization deals through special purpose vehicles, there is a stir in the securitization market. The principal investors (banks) were paying the tax on their net income from the securitization transaction through SPVs. Now, they will be taxed on the gross income as per the new Finance Bill. The new securitization guidelines issued in May 2012 dipped the volume of fresh issue to Rs. 28,400 crore from Rs. 44,500 crore in the preceding fiscal.

Non-banking finance companies, which raise funds by securitising their loan portfolio in favour of these banks, may have to shell out a higher interest rate as banks will try to pass on the additional tax burden on the issuer. The industry will go through a difficult phase again.

These changes in securitization rules forced us to revisit it and a sample survey of 30 banks and 13 non banking finance companies was conducted to elicit views on different aspects of securitization. The results revealed through research conducted to know preliminaries about securitization have been presented in various tables. Views expressed by rating agency CRISIL have also been incorporated at appropriate places. They are as follows-

Table 1
Securitization Transactions Held

Responses	Respondents		
	Banks	Others	Total
Yes	24(80)	13(100)	37(86)
NO	6(20)	------	6(14)
Don't Know	------	------	------
Total	30(100)	13(100)	43(100)

- Figures given in parentheses represent percentages.

The analysis reveals that a big majority of the banking respondents replied affirmatively to the query of holding of Securitization transactions where for second category of organizations, 100 percent respondents replied positively. It is true too, as all the banks have not tested the water of securitization. It may be said that Securitization is becoming popular with every passing day

Table 2
Securitization Motives

Motives	Respondents		
	Banks	Others	Total
To meet funds need	----	----	
To improve liquidity	09 (30)	07 (54)	16 (37)
For better asset-liability management	17 (57)	06 (46)	23 (53)
Competitors did it	----	----	----
Any other	04 (13)	----	04 (10)
Total	30 (100)	13 (100)	43 (100)

- Figures given in parentheses represent percentages.

True to the expectations and reality, table 2 depicts that 57 percent and 30 percent banking respondents found 'asset-liability management' and 'liquidity improvement' respectively the main motives for Securitization whereas in case of other organizations categories the same reasons were admitted by 46 percent and 54 percent respectively. It is obvious that 'banks' need more liquidity but for 'others' it is always the main cause of worry and that is why they undertake Securitization.

Table 3
Status of Securitization Market in India

Status	Respondents		
	Banks	Others	Total
Very Good	16 (53)	09 (69)	25(58)
Good	09 (30)	04 (31)	13(30)
Not Good	05 (17)	---------	05(12)
Total	30(100)	13 (100)	43(100)

- Figures given in parentheses represent percentages.

Table 3 explains the results of yet another related query about the status of Securitization market in India. A majority of the respondents of both categories observed it to be 'very good' and rest found it be only 'good' with an exception of 17 percent banking respondents finding it 'not good'. It may be concluded that Securitization market is having good status in India. The CRISIL rating agency has also observed it to be 'good'

Table 4
Future of Securitization Market in India

Responses	Respondents		
	Banks	Others	Total
Bright	08 (27)	04 (31)	12(28)
Encouraging	20 (67)	09 (69)	29(67)
Not Good	02 (06)	---------	02(05)
Total	30 (100)	13 (100)	43(100)

- Figures given in parentheses represent percentages.

Table 4 deals with the query of future of Securitization market in India. More or less, equal percentage of respondents of both categories of respondents find the future 'encouraging' and 27 percent and 31 percent respondents of respective categories rate the future of Securitization market as 'bright'. The results seem to be in conformity with results of preceding query. The top most rating agency of India CRISIL has also noted the future of Securitization market as ‘encouraging’. Hence, it may be concluded that Securitization stand good chances of success in India.

Table 5
Views about Success of Securitization Act

Views about success of Securitization Act	Respondents		
	Banks	Others	Total
It has succeeded	27 (90)	11(85)	38 (88)
It has not succeeded and will meet the fate of previous legislations	03 (10)	--------	03 (07)
It will prove a bigger failure	--------	--------	---------
Cannot say	-------	02 (15)	02 (05)
Total	30(100)	13(100)	43(100)

-Figures given in parentheses represent percentages

The next query posed to the respondents was to know their views about the success of Securitization Act. Their responses have been summarised under Table 5. It is evident from the analysis that almost all the respondents of both categories are sure about the success of the Act and their views are backed and based on ‘clarity of legal aspects’ about Securitization, ‘treatment of financial instruments as security receipts’, banking is viewed as ‘legal one’ and ‘better yields on securitized instruments’ in varying degrees. Hence, it may be concluded that enactment of law has boosted the confidence of the organizations carrying Securitization process. CRISIL attributes its success to clarity of ‘legal aspects’ of products made by the legislation. The rating agency also believes that ‘plethora of legislations’ has impeded the success of securitization Act.

Table 6
Preference for Assets of Securitization

Assets Preferred	Respondents		
	Banks	Others	Total
Existing assets	16 (53)	10 (77)	26(60)
Future receivables	07 (23)	03 (23)	10(23)
Loan Syndication	04 (14)	---------	04(09)
Derivatives	03 (10)	---------	03(08)
Total	30 (100)	13 (100)	43(100)

- Figures given in parentheses represent percentages.

The responses to an enquiry regarding particular type of assets’ preference for Securitization have been presented in Table 6. On overall basis, it can be said that ‘existing assets’ are preferred to other assets whereas 23 percent respondents of each category opined that ‘future receivables’ are also preferred to loan syndication and derivatives for the purpose of Securitization. It can be concluded that Securitization of future receivables is not that very popular as existing assets in India but it is also picking up with passage of time and placing of regulatory framework. The same views have also been expressed by CRISIL by describing the preference for ‘existing assets’ for Securitization and ‘future receivables’ holds potential for Securitization.

Table 7
Type of Loan Assets Securitized

Responses	Respondents		
	Banks	Others	Total
Residential Mortgage Loan	15 (50)	05 (38)	20 (47)
Credit Card Loans	03 (10)	-----	03 (07)
Automobiles Receivables	05 (17)	03 (23)	08 (19)
Leasing Contracts	---	02 (16)	02 (05)
Future Receivables	03 (10)	03 (23)	06 (13)
Any Other	---	--------	--------
DNR	04 (13)	--------	04 (09)
Total	30 (100)	13 (100)	43 (100)

- Figures given in parentheses represent percentages

To know further the type of loan assets securitized, the query results presented in Table 7 show that ‘residential mortgage loans’ are most favourable for Securitization for both categories of organizations followed by ‘automobile receivables’. Again, here it is proved that ‘future receivables’ have started finding favour with both types of organizations. CRISIL has outlined automobiles, future receivables, collateral debt obligations (CDOs), asset backed securities (ABS) and single loans sell down as the loan assets rated by it for Securitization.

Table 8
Homogeneity of Assets Offered as Collateral

Were assets offered as collateral homogeneous in nature?	Respondents		
	Banks	Others	Total
All of them	06 (20)	03 (23)	09 (21)
Some of them	11 (37)	04 (31)	15 (35)
Not at all	13 (43)	06 (46)	19 (44)
Total	30 (100)	13 (100)	43(100)

- Figures given in parentheses represent percentages

The loan assets to be securitized, if are homogeneous can facilitate the process of Securitization. Therefore, a query was raised to the respondents of both categories under study. The results are largely same under both categories indicating that securitisable assets may either be homogeneous or heterogeneous in nature. CRISIL has also expressed identical views by saying that it has rated mixed pools of assets comprising commercial vehicles, cars, utility vehicles, etc.

Table 9
Credit Enhancement Provided to Investors by SPV

Responses	Respondents		
	Banks	Others	Total
Yes	--------	03 (23)	03 (07)
No	05 (17)	04 (31)	09 (21)
Don't Know	06 (20)	--------	06 (14)
DNR	19 (63)	06 (46)	25 (58)
Total	30 (100)	13 (100)	43(100)

- Figures given in parentheses represent percentages

To create confidence amongst the investors to buy securities issued by SPVs/ Trusts, they provide credit enhancement by means of over collateralization, guarantee by third party, and insurance, etc. Therefore, an enquiry was posed to the respondents and results summarized in Table 9 shows that on overall basis a large number of respondents 'did not reply'. It lends credence to the assumption that respondents were either not aware of this aspect or did not deem it relevant to reply. The CRISIL has also observed the credit enhancement on the transactions rated by it in the form of pure cash collateral, over collateralization, mix of both cash and over collateralization and guarantees.

Table 10
Influence of Credit Enhancement on Marketability of Securities

Responses	Respondents		
	Banks	Others	Total
Yes	09 (30)	08 (62)	17 (40)
No	07 (23)	--------	07 (16)
Cannot say	06 (20)	05 (38)	11 (26)
DNR	08 (27)	--------	08 (18)
Total	30 (100)	13 (100)	43(100)

- Figures given in parentheses represent percentages

A related query was posed to the respondents to judge the impact of credit enhancement on marketability of securities. The percentage of respondents of 'others' category responding affirmatively to the enquiry was more than double that of banking respondents. It is also clear from the analysis that banking respondents are aware of the influence of credit enhancement on the marketability of securities, though they were ignorant about it in previous query. The rating agency CRISIL has also felt the influence of credit enhancement on the marketability of securities.

Table 11
Involvement of Credit Rating Agency in Securitization

Responses	Respondents		
	Banks	Others	Total
Yes	16 (53)	13 (100)	29 (67)
No	03 (10)	--------	03 (07)
Cannot say	11 (37)	--------	11 (26))
Total	30 (100)	13 (100)	43(100)

- Figures given in parentheses represent percentages

For boosting investors' confidence, another means considered necessary is rating of undertaken transactions for which services of Credit Rating Agencies are of utmost significance. To the poser of involvement of CRAs on Securitization, all the respondents of 'others' category replied affirmatively and majority of banking respondents admitted the involvement of CRAs in the process of Securitization. A good percentage of banking respondents are unaware of ratings by CRAs of Securitization transactions. The CRISIL has also confirmed its own involvement in majority of the Securitization transactions as it is the most successful and famous rating agency of India

Table 12
Extent of Investors' Confidence Enhanced by Ratings

Responses	Respondents		
	Banks	Others	Total
To a lot of extent	08 (27)	04 (31)	12 (28)
To some extent	10 (33)	03 (23)	13 (30)
Does not enhance	--------	--------	--------
DNR	12 (40)	06 (46)	18 (42)
Total	30 (100)	13 (100)	43(100)

- Figures given in parentheses represent percentages

In yet another query an effort was made to find out the extent of enhancement of investors' confidence by the ratings of rating agencies. The highest percentage of respondents of both categories 'did not reply' and no one 'denied' the enhancement under the query. It is also obvious from the analysis that if first two responses 'to a lot extent' and 'to some extent' are taken together, then majority of respondents of both categories are admitting to the enhancement of investors' confidence by the rating of rating agencies. CRISIL is, doubtlessly, of the view that rating enhances the investors' confidence. This will definitely lend to boost the securitization market.

Table 13
Securitized Instruments

Nature of securitized instruments issued by SPV/Trust	Respondents		
	Banks	Others	Total
PTC	14 (47)	13 (100)	27 (63)
PTS	--------	---------	--------
CMO	03 (10)	---------	03 (07)
Both I and III	13 (43)	---------	13 (30)
Others	--------	---------	--------
Total	30 (100)	13 (100)	43 (100)

- Figures given in parentheses represent percentages

The next query related to the instruments of Securitization covers the nature of instruments risk spread by these instruments and help rendered by these instruments in averting financial crises. The responses indicate that 'Pass Through Certificates (PTCs) are highly popular with 'others' than banking respondents whereas PTCs and CMOs (Collateralized Mortgage Obligations) are finding favour with banks. CRISIL has also recommended PTCs as securitized instruments. As regards to other aspects of securitized instrument, highest percentage of respondents of both categories are found to be ignorant about the risk spreading by these instruments where as 20 percent and 31 percent respondents of 'banks' and 'others' categories are aware about the risk spreading by the securitized instruments. 17 percent banking respondents refused to believe in the risk spread by the securitized instruments. CRISIL is of the opinion that risk is spread by these securitized instruments. Similarly 20 percent and 15 percent respondents of both the categories replied affirmatively to the averting of financial crises by these securitized instruments. CRISIL also finds itself on 'cannot say' option, means thereby it cannot be said that securitized instruments help averting the financial crises. Therefore, it may be concluded that it is not still clear whether securitized instruments spread risk and avert financial crises.

Table 14
Assets Servicer or Sub-Servicer

Asset servicer or sub-servicer engaged by SPV/Trust	Respondents		
	Banks	Others	Total
Yes	08 (27)	06 (46)	14 (33)
No	04 (13)	--------	04 (09)
DNR	18 (60)	07 (54)	25 (58)
Total	30 (100)	13 (100)	43(100)
Function of asset servicer or sub-servicer			
Collection of interest	-------	-------	-------

Repossession of properties	-------	-------	-------
Payment of Coupon interest and capital	-------	-------	-------
All of the above	08 (100)	06 (100)	14 (100)
None of the above	------	------	------
Total	08 (100)	06 (100)	14 (100)
Regular receiving of interest and capital repayment from original borrowers.			
Always	18 (60)	11 (85)	29 (68)
Occasionally	07 (23)	-------	07 (16)
Never	05 (17)	2 (15)	07 (16)
Total	30(100)	13(100)	43 100)

.Figures given in parentheses represent percentages

To a query whether services of an asset servicer or sub servicer were hired or engaged by the SPV/ Trust, highest number of respondents of both categories preferred 'not to reply' whereas 27 percent and 46 percent respondents of 'banking' and 'others' categories made the use of servicer or sub-servicer. CRISIL is also of the opinion that services of asset servicers or sub servicers should be taken to make the process of Securitization smoother and successful. It can be concluded that such specialised services improve the efficiency of the process of Securitization, as they perform the functions of collection of interest and capital, repossession of properties and payment of coupon interest and repayment of capital bonds and this is evident from the Table

Table 15
Cost-Benefit Analysis

Cost-benefit analysis undertaken for securitization	Respondents		
	Banks	Others	Total
Yes	23 (77)	07 (54)	30 (70)
No	--------	--------	--------
Don't Know	--------	--------	--------
DNR	07 (23)	06 (46)	13 (30)
Total	30(100)	13(100)	43(100)

- Figures given in parentheses represent percentages

Any activity undertaken in any organization should be subjected to cost benefit analysis and if benefits exceed its cost, it should be implemented and rejected otherwise. A majority of the respondents under both type of organizations said that it was undertaken and rest of them 'did not reply'. CRISIL also said that this was undertaken by organizations before going for Securitization. The banking organizations did the efforts of segmenting the market, creating several risk classes of bonds, credit enhancement and fixation of bid price while 'others' created risk classes of bonds, services of rating agencies and fixation of bid-price to assess the economic viability of the Securitization process of varying degrees.

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