Abstract: Securitisation has become a global financing tool. Countries such as Mexico, Brazil, USA, Canada, UK, France, Australia, Hong Kong, the Netherlands, Japan, Germany etc. have used some type of securitisation. Some of the assets securitised include credit card receivables, airline tickets, residential mortgages, car loans, swap contracts, tax lien, trade and export receivables, insurance premia, telephone receivables, oil and gas receivables, time-share cash flows, parking fines, cinema tickets, hire purchase / lease receivables and trade receivables.

Keywords: commercial - papers, interest-rates, liquidity, mortgage, PTC’s,Rating agencies, SPV, tranches.

1. INTRODUCTION

Securitisation of future receivables has started to become increasingly popular in India. Many Indian organisations have already started using this route for raising and investing funds. Banks, financial institutions, NBFCs, petroleum companies and refiners, housing finance companies, power generators and distributors etc. have all in general started exploring the possibilities of raising finance through the securitisation method.

Securitisation is a process whereby non-tradable or illiquid financial assets are transformed into tradable securities. It involves the transfer of an asset or a pool of assets, directly or indirectly, by the owner of the assets (“Originator”) to a special purpose vehicle (“SPV”) which is funded through an issue of debt securities or notes backed by the cash flows generated by the assets. Securitisation offers a numbers of advantages to Originators, to the investors and to the financial system of the country. From the Originator’s perspective, securitisation improves the liquidity position by replacing receivables by cash. It removes assets from the seller’s balance sheet, thus liberating capital for other uses. This leads to restructuring of the balance sheet by reducing large exposures or sectoral concentration. It leads to better asset liability management by reducing market risks resulting from interest rate mismatches.

Assets are more frequently recycled leading to an improvement in the earning. It also leads to transparency in the balance sheet as it results in identifiable assets. Securitisation provides a relatively risk-free investment for the investor. They are basically good-quality assets, helping the investors to diversify their portfolios. For the financial systems of the country, securitisation leads to an increase in the number of debt instruments in the market, and provides additional liquidity in the market. It may widen the market and lead to entry of new players due to the superior quality of assets being available.

Most of the securitisation deals are based on the structure as shown below:

2. KEY FEATURES OF SECURITISATION:

- All the risks and rewards associated with underlying pool are transferred to the buyer.
- The transaction structure should be such that the bankruptcy of seller does not affect the underlying pool.
- There is no recourse to seller once the underlying pool is sold.

3. DEVELOPMENTS IN SECURITISATION:

Securitisation has arrived in a developing country like India much faster than expected. Crisil, a rating agency in India, has reported that rated securitisation transactions have gone up from Rs. 143 crores (Rs. 1,430 million) in 1996-97 to Rs. 2,902 crores (Rs. 29,020 million) in 2001-2008. Securitisation has come a long way since the first such transaction for Rs. 160 million between Citibank and GIC Mutual Fund.

Amongst the other developments, the government of the state of Uttar Pradesh has securitized overdue payments to Housing and Urban Development Company (Hudco)
through tax-free bonds. The deal involves placement of 10.5 per cent tax-free bonds worth Rs. 50 crores (Rs. 500 million) with Hudco, with Rs. 27 crores (Rs. 270 million) in cash. This is the first instance of a state government using this route to settle payments. Although this deal was not based on a strong fundamental process, the very fact that this route is now a part of state government finances makes it a structuring to be recognised.

Hudco is now planning to conclude a Rs 500 crore (Rs. 5000 million) securitisation deal for the infrastructure sector, a first of its kind in this sector. The National Housing Bank has also entered into a securitisation deal involving four counter-parties, including HDFC, LIC Housing Finance, Canfin Homes and Dewan Housing.

The other corporations already using this form of financing or planning for the same include Videocon Power, Larsen & Toubro, IDBI, Citibank and GIC Mutual Fund. Meanwhile, the Karnataka Electricity Board has become the country’s first entity to conclude a securitisation deal in the power sector. It has securitised Rs. 194 crore worth of receivables and placed them with Hudco.

In a recent study the RBI has constituted an in-house working group, which has called for wide-ranging legal and taxation reforms to enable the introduction of securitisation deals in the country. The group has also asked SEBI to prepare guidelines for disclosure, investor protection and listing guidelines related to public issue or private placement of securitised instruments.

4. CURRENT SECURITIZATION ACTIVITY IN INDIA

To analyze the potential of securitization India, we split the securitization market into the following four broad areas:

Asset Backed Securities (ABS)

Asset backed Securities are the most general class of securitization transactions. The asset in question could vary from Auto Loan/Lease/Hire Purchase, Credit Card, Consumer Loan, student loan, healthcare receivables and ticket receivables to even future asset receivables. There has been moderate amount of activity on the Auto Loan securitization front. Companies like TELCO, Ashok Leyland Finance, Kotak Mahindra and Magma Leasing have been securitizing their portfolio of auto loans to buyers like ICICI and Citibank.

While many of the deals are bilateral portfolio buyouts, ICICI has used the SPV structure and placed the issuance privately to corporate investors and banks.

One of the first publicized structured finance transactions in India was the Rs. 4.09 billion non convertible debenture program by India Infrastructure Developers Ltd (IIDL), an SPV set up for building and operating a 90 MW captive co-generation power plant for IPCL (March, 1999). IIDL raised finances on the BOLT (Build Operate Lease Transfer) model on the strength of its future cash flows from IPCL and limited support from L&T. The transaction was rated AA- (SO) by CRISIL.

ICICI has done several bilateral asset backed securitization deals including securitizing DOT (Department of Telegraph) receivables from Sterlite Industries and Usha Beltron.

Mortgage Backed Securities (MBS, RMBS, CMBS)

The MBS market in India is nascent - National Housing Bank (NHB), in partnership with HDFC and LIC Housing Finance, issued India’s first MBS issuance. The potential of MBS in India, however, is huge. With NHB actively looking towards the development of a Secondary Mortgage Market (SMM). The MBS market in India could soon overtake the other securitization transactions in the country.

An MBS market can help small HFCs with good origination capabilities and limited balance sheet strength in staying profitable and concentrate on the housing loan origination. The most important roadblocks for MBS in India are lack of mortgage foreclosure norms and the high incidence of stamp duty for assignment of mortgage necessary for securitization.

Collateralized Debt Obligations (CDO, CLO, CBO)

In this era of bank consolidations, CDOs can help banks to proactively manage their portfolio. CDOs can also help banks in restructuring their stressed assets. ICICI made an aborted attempt to do a CBO issuance. The CDO market in India is, however, likely to grow slowly owing to its complexities. The taxation and accounting treatment for CDOs needs to be clarified.

Asset Backed Commercial Paper (ABCP)

Asset Backed Commercial Paper (ABCP⁵) is usually issued by Special Purpose Entities (ABCP Conduits) set up and administered by banks to raise cheaper finances for their clients. ABCP conduits are usually ongoing concerns with new CP issuances taking out the previous ones. Apart from legal requirements, an active ABCP market requires a large number of investors who understand the instrument and have appetite.

⁵ Source: HUDCO
5. KEY RISKS IN SECURITISATION

The key risks in a securitization transaction can be summarized as follows:

![Risk Diagram]

a) Credit Risk

It is the risk of non-payment by the underlying obligors, which is dependent on underlying obligor’s ability and willingness to pay. The underlying obligor’s ability to pay is primarily driven by adequacy and stability of income. Loan to value (LTV) ratio and income generating capability of the underlying asset will indicate the obligor’s willingness to pay. It analyzes the originator’s sourcing and credit appraisal system, historical portfolio performance (both static and dynamic performance data) and actual pool to assess the credit and liquidity risk.

b) Market Risk

i) Macro-economic risk - The macro-economic scenario affects underlying asset valuation, income generating capacity of the asset (if case of certain asset class), borrower’s income, market interest rates, etc. The expected economic scenario has an impact on future behavior of the pool. The regulatory scenario is also a critical aspect to consider for different asset classes, for e.g. change in regulations for repossession process.

ii) Asset risk - The general risk perception of the asset, introduction of new models/substitutes or new technology will directly impact the performance of pool. It considers the historical performance of asset-class and the factors expected to impact the future performance of asset-class to assess this risk.

iii) Prepayment risk – The prevailing and expected market interest rates and expected income levels will influence the prepayment rates. It assesses the historical prepayment rates observed for that asset class for originator as well as similar issuances. Based on the historical data and expected interest rates and income levels.

iv) Interest rate risk – The interest rate type mismatch may arise in case where the collections from underlying borrowers are based on fixed interest rate and the payouts to investors are based on floating rate and vice versa. The interest rate benchmark mismatch may arise when the both collections and payouts are based on floating rate but reference benchmarks are different.

c) Counterparty Risk

i) Servicer risk – The ability of the Servicer to service the pool over the tenure of the transaction is an important risk factor. Typically, the originator acts as a Servicer in Indian securitization transactions. The provision to appoint back-up Servicer is also considered for additional comfort.

ii) Commingling risk – The time lag between the collections from the underlying obligors and deposit into collection account give rise to commingling risk. To address the commingling risk, CARE considers the short term credit quality of the Servicer.

iii) Other Counterparty risk – The presence of other counterparties like collection account bank, credit collateral provider, etc. give rise to performance risk.

d) Legal Risk

The securitization transaction involves transfer of receivables which must be a ‘true sale’ as per law. This effectively means that the originator does not retain any control over the receivables. It should not contradict any of the terms of the underlying loan agreements. The trust / assignee should have unrestricted access to the receivables as well as credit enhancement, subject to terms of its utilization.

6. CASE STUDY - First Rated Securitisation of Micro Finance Loan Pool in India

In March 2009, IFMR Capital and Equitas Micro Finance Limited concluded the first-ever rated securitisation of a microfinance loan pool in India. The transaction involved the securitisation of a loan pool of about Rs 160 million originated by Equitas, a leading MFI with operations in the southern state of Tamil Nadu.

The transaction was structured and arranged by IFMR Capital, and the loan pool was purchased from the originator by a bankruptcy-remote special purpose vehicle (SPV) created specifically for this transaction. The SPV then issued pass through certificates (PTCs), thus allowing the cash flows from the loan pool to be transferred to the investors through the SPV.

CRISIL has rated the transaction which has two tranches of securities, the senior notes being rated ‘AA’ and the subordinated notes rated ‘BBB’. The rating process involved a comprehensive due diligence conducted by CRISIL covering:

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6 Rating Methodology for Asset/Mortgage backed Securities
The MFI’s performance and quality of the loan pool.

The structure of the transaction.

The extent of first and second loss default guarantee provided.

Legal aspects of the transaction.

The loan pool was securitised into the ‘AA’ rated Senior Notes (equal to 80% of issue size, i.e. Rs 125 million), which were subscribed to by Yes Bank, and ‘BBB’ rated subordinated notes (equal to 20% of issue size, i.e. Rs 31 million), which were purchased by IFMR Capital. Equitas provided a cash collateral equal to 11.7% of the issue size.

The senior note investor is provided protection to an extent of 31.7% of the issue size, in the form of the cash collateral from Equitas and the ‘BBB’ rated notes, which are fully subordinated to the senior notes, subscribed to by IFMR Capital. The extent of protection increases as the portfolio runs down.

IFMR Capital structured this securitisation also keeping in mind learnings from the US ‘sub-prime’ crisis. The sub-prime crisis in the US mortgage market showed that, when all risks are passed on to end investors, loan originators and financial intermediaries have no incentive to perform requisite due diligence at the time of originating and buying portfolios of loans. The first-loss risk that Equitas bears is to ensure that the originating MFI maintains high quality of origination and servicing.

The second loss piece, in the form of subordinated notes, provided by IFMR Capital ensures that it has an incentive to conduct robust pre-purchase due diligence to. Each party in the transaction thus takes risks that it is best equipped to handle and the structure ensures that the incentives of all parties are aligned. Within six months of the transaction, both the tranches of PTCs received a ratings upgrade by almost 3 notches.

7. CONCLUSION & RECOMMENDATIONS

While more complex securitization transactions and public issuance of securitized paper are still a distant dream, appropriate legislation and investor education can give the securitization market in India a much-needed thrust. The RBI’s working group and the SEBI are actively working towards making the necessary amendments in the existing laws of the country. There is a scope for securitisation in a wide range of assets in India. It is envisaged that this form of financing would be used more extensively as a source of funds in future, at least as compared with the present-day situation. Also, care should be taken to examine the mechanism for enforcement of security interest provided in the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI) to suggest further measures to strengthen the enforcement of mechanism.

8. REFERENCES


