Structured Finance and Securitization in India

Akhil M P
Research scholar, Department of commerce, University of Kerala, Thiruvananthapuram
Ambalathuvila veedu. Muthiyavila .Kattakada. Kerala. India

Abstract

Structured financing is customized debt financing which fulfills the needs of the issuer where other standard financial products cannot meet. The popular as well as widely used structured financing alternative is securitization. The market for securitization products in India shows a greater growth and tends to innovation. The securitized products are blamed as one of the causes of the International financial crisis in 2008 why because the market for securitized products is unregulated. Its impact on Indian economy was either limited or no impact because of India's restrictive market practices. After the economic crisis, Indian banking regulators imposed a prudential regulation on assignment and securitization of standard and non-performing assets in tone with global norms. Apart from direct assignment by one financial institution to other, there are two major structures namely pass-through structure and pay – through structure. In India pass-through structure is extensively used, in rare cases pay-through structure used within the pass- through structure. Pass- through structure is typically in the form of securitized paper called pass-through certificates (PTCs). There is no institutionalized set up for regulating securitization in India. Reserve Bank of India (RBI) is now supporting securitization market. The RBI has also significantly contributed to the market by constantly reviewing and strictly implementing the Priority Sector Lending (PSL) norms. Indian banks and NBFCs are showing an increased participation in the securitization market. Major areas of securitized products are housing loan, commercial vehicle loan, and microfinance. This paper concentrates on structured finance and securitization in the Indian scenario.

Keywords – *Structured Financing, Securitization, Pass–through Structure, Special Purpose Vehicle*

I. INTRODUCTION

Structured financing is the process of generation of marketable securities through pooling of assets usually through a special purpose vehicle (SPV), which reduces the credit risk of originator and also imported cash generation from the assets. It involves the conversion of cash flow from a portfolio of assets in negotiable instruments or assignable debts which are sold to investors Careful regulation is a prerequisite for structured finance to ensure consistency across the globe. Structured financing is a new form of debt financing that meets the need of issuer needs as per the situation demands where the standard financial products cannot meet. Securitization involves packaging and structuring of a bundle of cash generating assets (receivables, mortgage loans, futures revenues) in to marketable securities which can be easily sold able to investor.

II. STRUCTURED FINANCE

Structured finance is an innovative financing instrument which meets the issuer and investors needs that standard financial products cannot meet. Structured finance involves the pooling of assets and the subsequent sale to institutional investors of claims on the cash flows backed by these pools. An important characteristic of this type of finance is the delinking of the collateral assets pool from the credit risk of the originator, usually through the use of a special purpose vehicle. The most popular and widely used structure is securitization, securitization involves structuring and pooling of cash generating assets into marketable securities through creating a special purpose vehicle.The market for securitization products in India shows a greater growth and tends to innovation. The securitized products are blamed as one of the causes of International financial crisis in 2008 why because market of securitized products is unregulated. Its impact on Indian economy was either limited or no impact because of India's restrictive market practices. After the economic crisis Indian banking regulators imposed a prudential regulation on assignment and securitization of standard and non-performing assets in tone with global norms. Apart from direct assignment by one financial institution to other, there is two major structures namely pass – through structure and pay – through structure. In India pass - through structure is extensively used, in rare cases pay-through structure used with in the pass-through structure. Pass- through structure is typically in the form of securitized paper called pass-through certificates (PTCs). There is no institutionalized setup for regulating securitization in India, the Reserve Bank of India (RBI) is supporting securitization market. The RBI has also significantly contributed to the market by constantly reviewing and strictly implementing the Priority Sector Lending (PSL) norms. Indian banks and NBFCs are showing an increased participation in the securitization market. Major areas of securitized products are housing loan, commercial vehicle loan and micro finance.

III. SECURITIZATION - AN OVERVIEW

The term securitization may be referred to as creation of security in any financial transaction. In this respect, security means a financial claim which is generally exhibited in the form of a document and whose essential feature is marketability. Therefore, securitization, or in other words, asset or receivable securitization means creation of marketable or tradable securities based on cash flows of an entity's assets or receivables. It is a device of structured financing (i.e. the financing that is tailored as per the risk-return and maturity needs of the investors) by way of which the originator pools together its interest in perceptible cash flows on assets receivables over time, sell such interest to an entity known as Special Purpose Vehicle (SPV), or Special Purpose Entity (SPE) and thereby achieve the purpose of financing.

IV. KEY CONCEPTS

Securitization is a process through which homogenous illiquid financial assets are pooled and repackaged into marketable securities. Generally, the assets are held in a bankruptcy remote vehicle termed as a Special Purpose Vehicle (SPV) or are otherwise secured in a manner that gives the investors a first ranking right to those assets.

The intent of securitization typically is to ensure that repayment of the securities issued to investors is dependent upon the securitized assets and therefore will not be affected by the insolvency of any other party including the entity securitizing the assets. Most securitization issues are rated by an accredited credit rating agency. The rating applies to the securities that are issued to investors and indicates the likelihood of payment of interest and payment of principal in full and on time.

Securitization involves isolation of specific risks, evaluation of the same, allocating the risks to various participants in the transaction (based on who is best equipped to mitigate the respective risks), mitigating the risks through appropriate credit enhancement structures and pricing the residual risk borne by the originator. It entails evaluating the transaction from the legal, regulatory, taxation and accounting implications from the perspective of various participants.

In a securitization transaction, the assets to be securitized are transferred by the asset owner (the originator or transferor) to a special purpose vehicle (SPV) as the asset purchaser. The SPV may be a corporation, trust or other independent legal entity. The SPV issues securities to public or private investors, which are backed (i.e. secured) by the income flows generated by the assets securitized and sometimes also by the underlying assets themselves. The net proceeds received from the issuance of the securities are used to pay the transferor for the assets acquired by the SPV.

Securitization transactions deal with various asset classes that include, among others, mortgages, automobile loans, aircraft, equipment and municipal leases, credit card receivables, hospital, retail, royalty and trade receivables, real estate, purchase contracts for natural resource assets such as oil, gas and timber, student and home equity loans, etc., and has emerged as an efficient and cost-effective efficiency resource raising mechanism with the potential to integrate the apparently illiquid underlying assets with the capital markets.

From an originator's perspective, the main advantages of securitization include the ability to raise finance at a relatively low cost, partial or total removal of assets from its balance sheet, diversification of funding sources, access to the capital markets for unrated entities and access to liquidity. Thus it serves as an effective balance sheet management tool for originators, through which hidden values could be identified and unlocked, asset-liability mismatch, currency, commodity and interest rate risks could be hedged and an enhanced return on capital and equity could be managed through the continuous churning of portfolio. Additionally, banks that raise funds through securitization are able to reduce their regulatory, and sometimes economic, capital requirements.

From an investor's perspective, securitization offers an alternative investment medium which, for a given rating level, usually offers a safer investment avenue and higher risk-adjusted returns compared to equivalent rated bank or corporate debt.

Depending on the originator's financing requirements, and the characteristics of the underlying assets, funding can be arranged through term securities, balance sheet warehouse facilities or asset backed commercial paper.

V. PARTICIPANTS

The following parties are involved in a typical securitization transaction:

A. Originator

This is the entity which requires the financing and hence drives the deal. Typically the Originator owns the assets or cashflows around which the transaction is structured.

B. SPV (Special Purpose Vehicle)

An SPV is typically used in a structured transaction for ensuring bankruptcy remoteness from the Originator. The SPV is the issuer of securities. Typically the ownership of the cashflows or assets around which the transaction is structured is transferred from the Originator to the SPV at the time of execution of the transaction. The SPV is typically an entity with narrowly defined purposes and activities and usually has independent trustees/directors. The SPV needs to be capital efficient (i.e. nominally capitalized) and tax efficient (i.e. multiple taxation should be avoided).

C. Investors

The investors are the providers of funds and could be individuals or institutional investors like banks, financial institutions, mutual funds, provident funds, pension funds, insurance companies, etc.

D. Obligor(s)

The Obligor is the Originators debtor. The amount outstanding from the Obligor is the asset that is transferred to the SPV. The credit standing of the Obligor(s) is of paramount importance in a securitization transaction.

E. Guarantor / Credit Protection Provider / Insurer

These are entities that provide protection to the Investor for the investment made in the securities and the returns thereon against identified risks. Typically, on the happening of pre-identified events, affecting the underlying assets or cashflows, or the payment ability of the Obligors, these entities pay moneys that are passed on to the Investor.

F. Rating Agency

Since structured finance deals are generally complex with intricate payment structures and legal mechanisms, rating of the transaction by an independent qualified rating agency plays an important role in attracting Investors.

G. Administrator or Servicer

The Servicer performs the functions of collecting the cashflows, maintaining the assets, keeping records and general monitoring of the Obligors. In many cases, especially in the Indian context, the Originator also performs the role of the Servicer.

H. Agent and Trustee

The Trustee is the manager of the SPV and plays a key role in the transaction. The trustee generally administers the transaction, manages the inflow and outflow of moneys, and does all acts and deeds for protecting the rights of the Investors, including initiating legal action against various participants in case of any breach of terms and triggering payment from various credit enhancement structures etc.

I. Structurer

Normally, an investment banker acts as the Structurer and designs and executes the transaction. The Structurer also brings together the originator, credit protection provider, the investors and other parties to a deal. In some cases the Investor also acts as the Structurer.

VI. REASONS FOR SECURITISATION

A. ***Meeting regulatory requirements*** - Banks must have mandatory minimum exposure levels in identified priority sectors.

B. ***Alternate and rated instruments*** - Securitization is a plain vanilla option for funding outside of the balance sheet. When done through PTCs that are rated, there is some level of comfort with the instrument due to third party validation.

C. ***Cost of financing*** - As the originator has already invested time and effort on risk analysis at the time of lending, securitization allows the purchaser to take comfort from this analysis, thereby reducing the total cost of financing.

D. ***Frees up capital for lending*** - Originators can securitize assets from their balance sheets, thereby increasing the pool of available capital that can be used for investment. In addition, since securitization normally requires less capital to support it than traditional on-balance sheet funding, it enhances return on capital.

E. ***Reduces credit exposure to a specific type of asset*** - If a particular class of lending forms a larger proportion of the balance sheet as a whole, then securitization can remove some of the assets (of a particular class) from the balance sheet.

F. ***Makes non-tradable assets tradable*** **-** This, along with the promotion of a regular market for securitized paper, enhances liquidity in a variety of previously illiquid financial assets.

VII. SECURITIZATION IN INDIA

The major players in the asset securitization market in India are Commercials Banks (FIs), Public Sector undertakings (PSUs), Corporate Entities, Governmental Agencies, Mutual Funds, NBFCs, etc. Securitization in India has been in existence since early 1990s. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was enacted in 2002. The objective behind its enactment was the sale or securitization of Non-Performing Loans (NPLs) by banks and financial institutions in favor of Assets Reconstruction Companies (ARCs) registered with the Reserve Bank of India (RBI) under SARFAESI. These guidelines are expected to have a far reaching impact on several issues and facilitate the development of a vibrant and robust securitization market in India. Funds of a firm get blocked in various types of assets such as loans, advances, receivables etc. To meet its growing funds requirements, a firm has to raise additional funds from the market while the existing assets continue to remain on its books. This adversely affects the capital adequacy and debt equity ratio of the firm and may also raise its cost of capital. An alternate available is to use the existing illiquid assets for raising funds by converting them into negotiable instrument.

The market for securitization products in India shown a greater growth and tends to innovation. The securitized products were blamed as one of the cause in connection with financial crisis of 2008 why because of which is unregulated. Impact on Indian economy was limited or no impact because of India's restrictive market practice. After the economic crisis Indian banking regulators imposed a prudential regulation on assignment and securitization of standard and non-performing assets tone with global norms. A part from direct assignment by one financial institution to other there are two major structures namely pass –through structure and pay – through structure. In India pass - through structure is extensively used, rarely pay-through structure used with in the pass- through structure. Pass- through structure is typically in the form of securitized paper called pass-through certificates (PTCs).

VIII. THE SECURITIZATION MARKET - INTERNATIONAL EXPERIENCE

The securitization market in the US has a fairly long vintage, with the Federal Government supporting the MBS market through institutions like the Freddie Mac, Fannie Mae and Ginnae Mae. Over the last quarter of a century, securitization has become one of the largest sources of debt financing in the US representing around 30% of the total outstanding US bond market and is enjoying extraordinary growth. Between 1996 and 2004, the market grew at an average rate of 19% per annum from US$ 152 billion (in 1996) to US$ 624 billion (in 2004). In fact, the growth rate has been showing an uptrend in the recent past with the CAGR between 2001 and 2004 being 28%. Despite being the most matured market, traditional asset classes such as the MBS (72%) and ABS including CDOs (14%) have driven the volumes in the US, the balance being contributed by FFS transactions (credit cards, student fees, etc.). In 2005, the market issuances till date gross up to US$ 176 billion (as compared to US$ 167 billion achieved during the same period in 2004). The share of the traditional asset classes like MBS stands at 70% with ABS including CDOs contributing to around 19% of the issuance volumes.

European securitization market began in the mid-1980s with UK leading the way with an MBS issue in 1986. For a long period, issuance volumes were modest with UK and France being the dominant markets. Bulk of the volumes was accounted for by traditional MBS and ABS (mainly CDOs) transactions. However, at present, Europe provides a thriving securitization market. Between 1997 and 2003, the market grew at an average rate of 23% per annum from US$ 66 billion (in 1997) to US$ 285 billion (in 2004). In fact, the growth rate for the European market between 2001 and 2004 being 39% much exceeds the growth rate of the US markets during the same period. In 2005, the year to date volumes of securitized paper amount to US$ 71.5 billion as against US$ 72.6 billion in the corresponding period in 2004. MBS (60%) and ABS including CDO (28%) continue to dominate the issuances in Europe. In terms of countries of origin, UK leads the pack with a market share of around 45%, followed by Italy with a share of around 14%, while Spain and Netherlands have around 8% share each. Other significant countries of origin are Germany and France. In terms of currencies of issuance, around 64% of the issuances are Euro denominated, around 21% are denominated in GBP while the remaining are denominated in US$.

IX. INDIAN EXPERIENCE

The Indian securitization market has seen the emergence of diverse asset classes though volumes are driven by traditional asset classes such as auto loan receivables and mortgage backed receivables. The fiscal year 2003-04 witnessed around 82% of the market volumes being contributed by auto loan receivables and mortgage backed receivables. Emerging asset classes include toll receivables, telecom receivables, electricity receivables, fee receivables, deferred tax receivables, etc. The market has already witnessed the entry of international players such as IFC in the role of credit protection providers. The government is also expected to emerge gradually as a key market participant with increasing realization of the potency of securitization as a means to raise low cost resources. However, the markets remain shallow as issuances continue to be restricted to a handful of high quality originators and a majority of the transactions are bilateral. Moreover, the investor base continues to remain small, especially for the long-tenured transactions.

The first securitization transaction in the Indian market happened in 1991 where Citibank N.A originated an auto loan receivables securitization deal. In the next six years, the market witnessed 12 more ABS issuances, all auto loan receivable securitization transactions. In 1997, the markets suffered a major setback as the auto loan market crashed on account of a number of defaults from Non-Banking Finance Companies (NBFCs). The market for securitized instruments started picking up again in fiscal year 2000-01. The year witnessed a total volume of Rs. 29.00 billion (~US$ 640 million) from 19 issuances by eight originators. The fiscal year 2001-02 witnessed 25 issuances from 11 originators totaling Rs. 36.82 billion (~US$ 820 million). This was followed by 73 issuances from 18 originators amounting to Rs. 77.66 billion (~US$ 1,725 million) in fiscal year 2002-03, 87 issuances from 22 originators amounting to Rs. 137.62 billion (~US$ 3,050 million) in fiscal year 2003-04, while in fiscal year 2004-05, there have been 123 issuances in all from 27 originators, grossing up to Rs. 313.08 billion (~US$ 7,116 million). Thus between fiscal years 2001-02 and 2004-05, the securitization market in India has registered a growth rate of over 100% per annum. Despite this scorching pace of growth, the market size, in comparison with the developed international markets (US$ 626 billion in the US and US$ 282 billion in Europe in 2004), might not seem to be noteworthy. However, the same assumes significance given the fact that the Indian markets have started growing only in the last couple of years.

On the origination side, the participants are primarily banks, Non-Banking Finance Companies (NBFCs), Housing Finance Institutions (HFIs) and to a very limited extent, corporates. On the investment side, Mutual Funds are major participants in the securitization 1 Source: Global Structured Finance Research, J.P. Morgan Securities Inc., New York weekly publications between September 2004 and April 2005 market, apart from the aforesaid players, especially in the shorter-terms. Besides, insurance companies and corporates, to a limited extent have started investing in these papers.

ICICI Bank, the second largest commercial bank in India has been an active player in the domestic securitization market since 1997. Presently ranked the largest player in the market on the originating side with an overall share of around 42% (for fiscal year 2004-05), the bank has contributed to a considerable extent in expanding the market horizons primarily by enhancing origination volumes and attracting different investor categories as well through innovative structuring and pioneering marketing efforts within a short span of time.

Issuances of largest single transactions in terms of size domestically in almost all underlying asset classes stand to the bank's credit [auto pool receivables Rs. 16.32 billion (US$ 370.91 million); mortgage backed receivables Rs. 11.94 billion (US$ 271.36 million); personal consumer loan backed receivables Rs. 6.56 billion (US$ 149.09 million); multi-obligor CDO Rs. 0.94 billion (US$ 21.36 million)].

Introduction of temporal trenching (Nov 2001) non-funded risk participation (Sep 2002), book building (Dec 2002) and market making (Apr 2003) of securitized papers, par issuances as against the practice of premium issuances prevalent in the markets (May 2003), carving out a prepayment tranche to insulate other senior tranches from prepayment risk (Oct 2003) and issuance of a multi-obligor CDO (Jan 2004) are among the many firsts to the bank's credit in India. Besides, the bank has also worked on other innovations such as offering floating yield structures linked to transparent benchmarks, revolving structures, etc. and ramped up its market issuances further.

Efforts such as these helped the bank achieve a volume of Rs. 8.26 billion in fiscal year 2002-03 and ramp it up more than tenfold to Rs. 129.57 billion in fiscal year 2004-05.

With a legal framework specific to securitization being put in place, rationalization of stamp duty considerations for securitization (which earlier ranged anywhere between 10% and 28% in various states) being effected in six of the 28 states, a detailed accounting framework for securitization laid down by the Institute of Chartered Accountants of India (ICAI) and Reserve Bank of India (the central bank in the country) taking steps to encourage securitization in India by offering capital relief on mortgage backed assets to banks and financial institutions investing in securitized papers, it could now be said that the Indian market has overcome the initial challenges and is gradually coming of age. With time, it is expected that the market participants will increasingly be forced to compete and be judged through their internal strength and capital base rather than by the external support from the central bank or the government while market penetration of financial institutions in the area of loan origination in future will be determined more by the volume of loans originated during a period than by the amount of loans owned at a particular point of time. As the structure of the financial system evolves over time, it is expected that securitization will play a much more important role in the future. However, the securitization market in India still continues to lack the requisite depth, which manifests in the form of securitized papers attracting a premium over corporate bonds with comparable risk profiles. It is hoped that with time, as pass through certificates issued in the process of securitization are recognized as securities like the regular debt instruments such as bonds, debentures, etc., the market would gather further momentum and the illiquidity premium prevailing now would eventually disappear.

X. CONCLUSION

Securitization in an emerging market like India has huge growth potential. The introduction of SecuritizationActis a step towards the development and regulation of an efficient securitization and structured finance market. Further, India's market offers great potential to the foreign players to explore and create niche for themselves.India has been trying hard to catch up with the latest economic developments. Securitization and structured finance has only been a recent phenomenon, with the regulatory provisions only recently being introduced. There is however increasing acceptance of this mechanism in Indian market and it has a great future in the growing Indian economy.

REFERENCE

[1] Agboyibor, P. K., Tallot, P. and P. (2008). "France: A New Legal Framework For Securitization", Structured Finance Department, Orrick, Paris
[2] Kanwal, A. (2007). "Asset Securitisation in India: The Ignitive Tool for the Indian Capital Markets", International Journal of Business Research
[3] Securitization: The Financial Instrument of the Future, Wiley
[4] Khan, M. Y. (2007). Financial Services, The McGraw-Hill Companies.
[5] www.rbi.org.in
[6] www.books.google.co.in
[7] www.securitisation.it
[8] www.crisil.com
[9] www.wikipedia.com
[10] www.investopedia.com