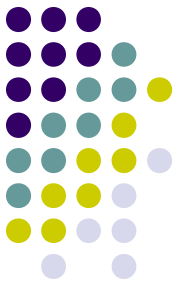


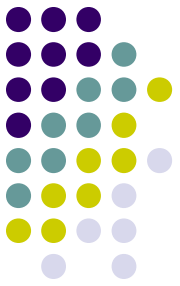
# Securitization

# AGENDA



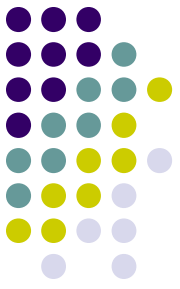
- Concept of Securitization
- Securitizable Assets
- Need for Securitization
- Process of Securitization
- Participants in Securitization Process
- Mechanism of Securitization
- Benefits of Securitization
- Risk Assessment in Securitization
- Problems in Securitization in India
- Regulations of Securitization in India

# Concept of Securitization



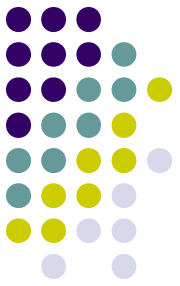
- Securitization refers to conversion of illiquid assets into liquid assets. It is a process of selling of assets by the person holding them, to an intermediary who in turn will break such assets into marketable securities.
- Securitization is a process used by banks to create securities from loans and other income producing assets. The securities are sold to investors. This removes the loans from the banks' Balance sheets and enables the banks to expand their lending faster than they would otherwise be able to do.
- In securitization, homogeneous pool of assets are identified and then they are packaged into a new instrument that can be sold to investors, whose payments are supported by the cash flows from that pool.

# Continued...



- Securitization is a structured financing arrangement.
- The term structured finance implies that a financial instrument is structured or custom made to suit the risk-return, and maturity needs of the investor, rather than being a simple claim against an entity.
- In a structured finance arrangement, the essential characteristic of promise to repay the investor in a security is backed by
  - 1.) The value of the underlying financial asset
  - 2.) The credit support of a third party to the transaction
- The firm that securitizes the debt, fixes the terms of the instrument in such a way that it suits the various risk-return preferences of investors.

# Continued...



- For example, in case of housing loans, there could be a portfolio of loans with different maturities. When these loans are bundled together for the purpose of securitization, an investor could choose a securitized paper with a specific maturity period that suits his needs.
- In Securitization, the servicing of the securitized paper is tied up with the cash flows of the specific asset pools identified for the purpose.

# Securitizable Assets

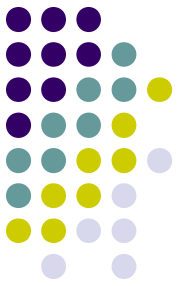


## ❑ Mortgage-Backed Securities

1. Residential Mortgage Loans
2. Commercial Mortgage Loans

## ❑ Asset-Backed Securities

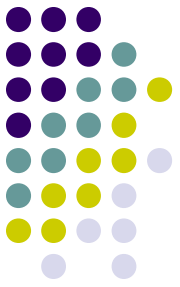
1. Credit card Receivables
2. Auto Loan Receivables
3. Personal Loan Receivables
4. Lease Receivables
5. Trade Receivables
6. Export Receivables



## Continued...

- Any resource with predictable cash flows can be securitized as follows:
  - Bills that are made at a five star hotel.
  - Tickets that are to be solved at a cinema hall.
  - Future billings of an airline.
  - Hire Purchase receivables.
  - Non-performing assets of a financial entity.

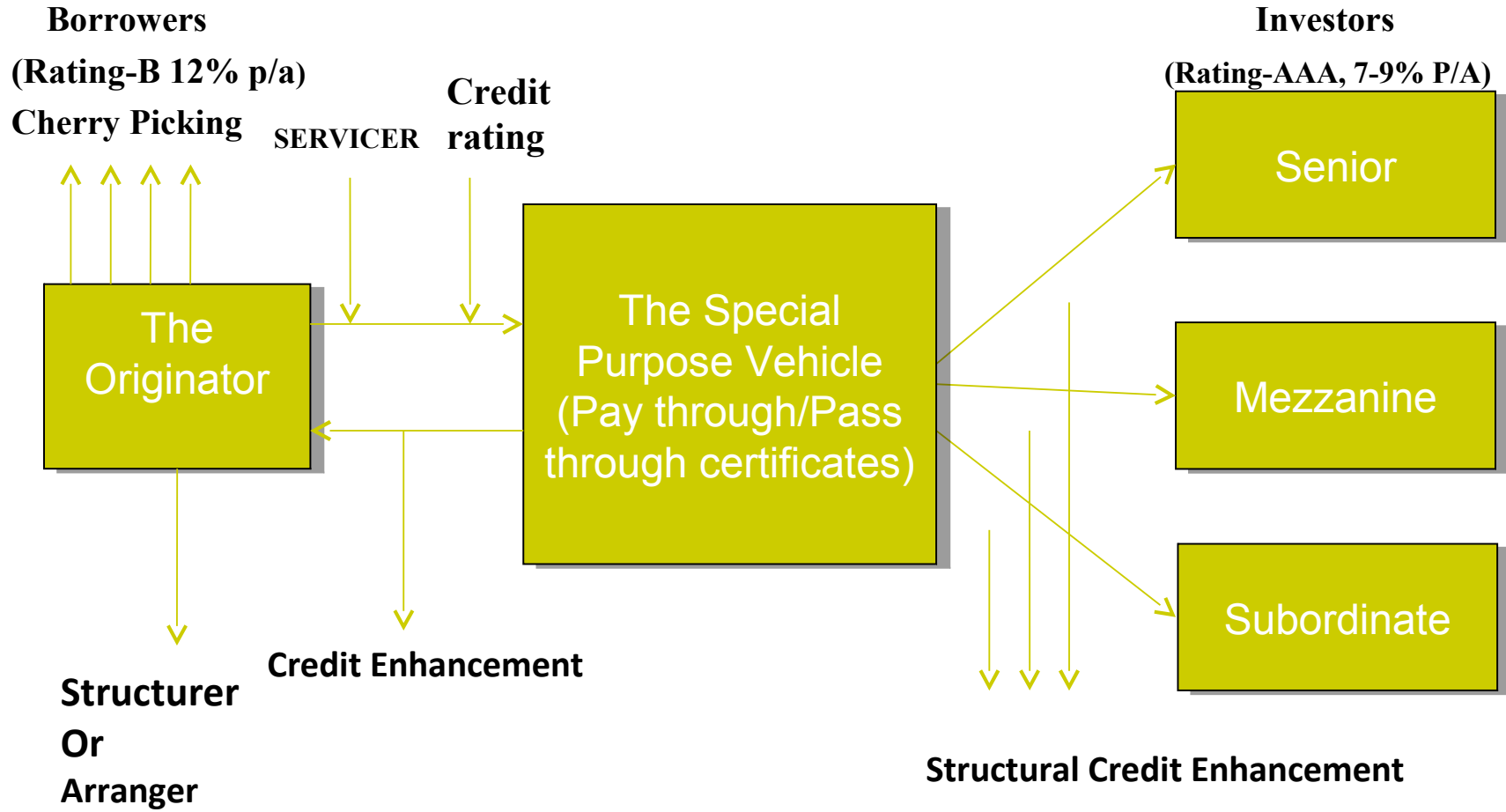
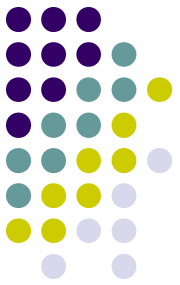
# Need For Securitization



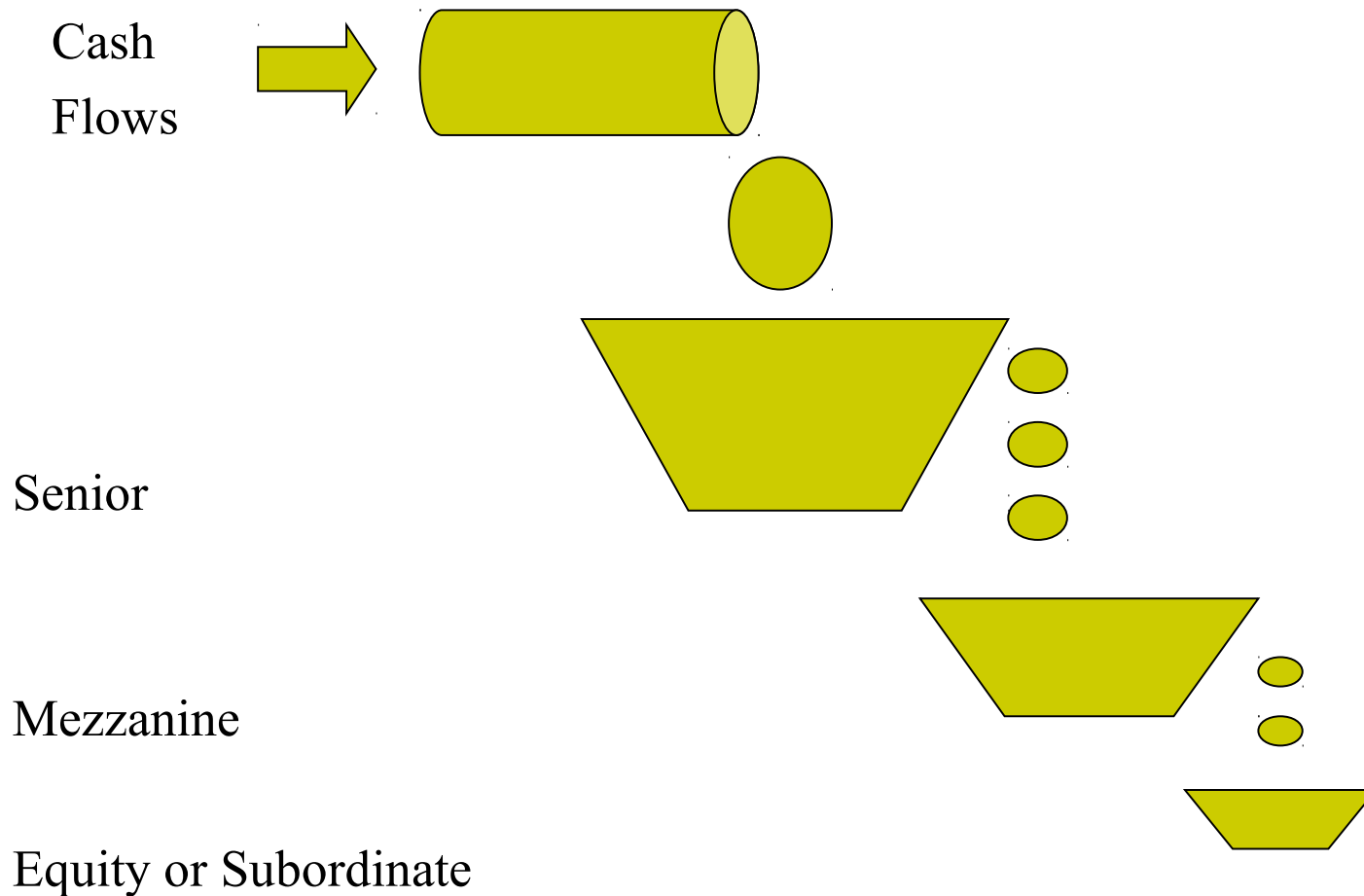
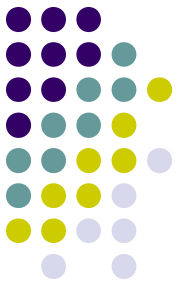
- For the requirement of Funds, as securitization is a mode of financing.
- Enhancing Liquidity.
- Off balance sheet financing - removal of accounts.
- Need for Asset-liability management of Financial institutions.



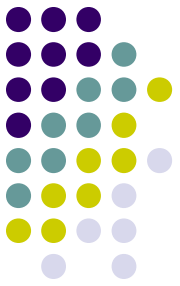
# Process of securitization



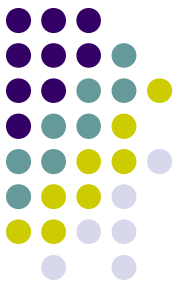
# The Waterfall in Securitization



# Participants in the Securitization Process



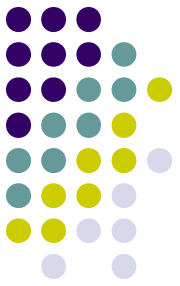
- **The Originator:** A firm that wants to securitize its assets is called originator.
- **The servicer or Administrator:** It collects the payment due from the Obligor/s and passes it to the SPV, follows up with delinquent borrowers and pursues legal remedies available against the defaulting borrowers. Since it receives the installments and pays it to the SPV, it is also called the Receiving and Paying Agent.



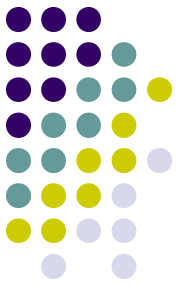
## Continued...

- **The Special Purpose Vehicle:** The issuer also known as the SPV is the entity, which would typically buy the assets (to be securitized) from the Originator. SPV is an entity specially created for the purpose of executing the deal. The originator transfers the assets in its books to the SPV which holds the legal title to the assets. It makes the payment to the originator for the assets purchased
- **The Investors:** Normally, the investors are financial institutions, mutual funds, provident funds, pension funds, insurance companies etc. The investors receive the interest and principal amount as per the agreement.

# Continued...



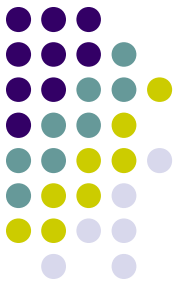
- **The Obligor:** He is the original borrower who has raised the loan from the originator. It is his outstanding loan amount that is transferred to the SPV.
- **The Rating Agency:** The investors take on the risk of the asset pool rather than the originator. The rating agency, therefore assess the strength of the cash flow and the mechanism designed to ensure timely payment to the investors.
- **Credit Enhancer:** The credit enhancer provides the required amount of credit enhancement to reduce the overall credit risk of a security issue. The purpose of credit enhancement is to improve the credit rating and thereby improve the marketability of the instrument.



## Continued...

- **Arranger or Structurer:** An investment bankers act as structurers. Their role is to bring together all the parties to the deal and structure the deal.
- **Trustee:** It accepts the responsibility for overseeing that all the parties to the securitization deal perform in accordance with the trust agreement. An agent is appointed essentially to look after the interests of the investors.

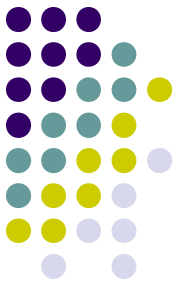
# Mechanism of Securitization



## Pass-Through Certificates:

- In a PTC, the SPV issues PTCs which are essentially participation certificates that enable the investors to take a direct exposure on the performance of the securitized assets. These certificates imply that the investors hold a proportional beneficial interest in the assets held by the SPV.
- Investors are serviced as and when cash flows are generated from the underlying assets.
- Any delay or disruption in cash flows is shielded to the extent of the credit enhancement available.
- In PTCs, the securities are serviced directly from the cash flows or the installment of the loans.
- Car loans and housing loans are some of the cases where PTCs are issued

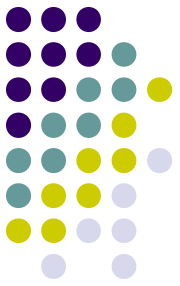
# Continued...



## **Pay-Through structure:**

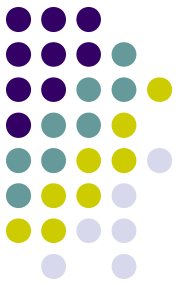
- A pay through structure gives only a charge against the cash flows arising from the securitized assets while the ownership of the assets lies with the SPV.
- In a pay-through arrangement, cash flows of the underlying assets and the services of the securitized papers are delinked.
- The SPV issues a secured debt instrument to the investors as a securitized paper.





# Continued...

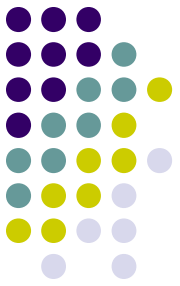
- The SPV invests all the cash flows received from the asset pools in govt. securities or other securities.
- Later, the proceeds from such investments are used to service the investors.
- The SPV has to do effective cash management to service the investors.



# Benefits of Securitization

- **For Originator**
  1. Off-balance sheet financing.
  2. Improves capital requirements.
  3. Enhances Liquidity
  4. Concentrate on core business.
  5. Reduction in borrowing costs.
  6. Another mode of Financing.

# Continued...



- **For Investors**
  1. Advantage to earn a high return on risk adjusted basis.
  2. Opportunity to invest in a pool of high quality credit-enhanced assets
  3. Portfolio diversification – alternate investment vehicle.
  4. Bankruptcy Remoteness – Investors are not affected by the insolvency of the originator.

# Risk Assessment in Securitization



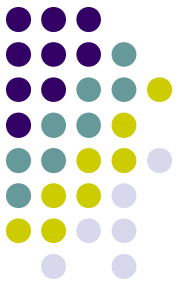
- Collateral Risk: Extent to which the borrowers of underlying assets will default.
- Structural Risk: Risk involved in passing on the cash flows from asset pools and credit enhancement to the investors.
- Legal Risk: Extent to which the regulatory action can delay or prevent the payment to investors.
- Third Party Risk: Failure of performance of third parties such as servicer, trustees, bankers etc.

# Problems in Securitization in India



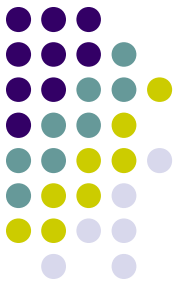
- **Stamp Duty:** is heavy in some states.
- **Accounting Treatment:** No clear guidelines
- **Lack of Standardization:** Format of the mortgage loan agreement is not uniform.
- **Foreclosure Laws:** No separate Law for securitization.

# Regulation of Securitization in India



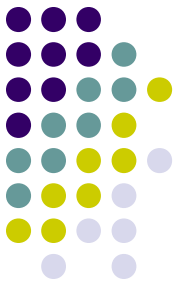
- There is no specific regulatory framework for securitization in India.
- The enactment of securitization and Reconstruction of Financial Assets and Enforcement of Security interest Act (SARFAESI Act)-2002 was the first legislative step that enabled the securitization of the NPAs of Banks and FIs.
- The High Level Committee on corporate Debt and Securitization (Patil Committee) constituted in 2005 is an important development in the Indian Financial system.
- The RBI guidelines for securitization of standard assets by banks was issued in 2006 on certain key aspects of securitization such as the true sale criteria, capital treatment etc.

# Continued...



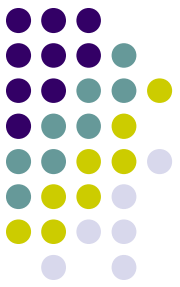
- In 2007, SCRA (Securities Contract Regulation Act) was amended to include the securitized instruments in the definition of the term securities.
- This has led to listing and trading of securitized papers in the stock exchanges.
- SEBI has released draft regulations for public offering and listing of securitized debt instruments in June 2007, which is yet to be formalized as a regulation.

# Glossary

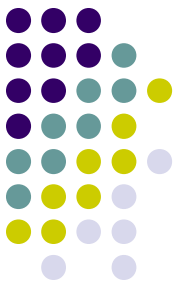


- Asset Backed Securities: Securities backed by receivables other than those arising out of real estate.
- Mortgage Backed Securities : Securities carved out of receivables from mortgage funding
- Bankruptcy Remote : SPV or investors are not affected by insolvency of originator
- Seasoning: Seasoning refers to monitoring the performance of the selected assets over a period of time, say 6 months, to ensure that all the cherry picked assets are sound assets.

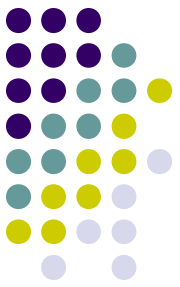




- Cherry Picking : Picking up selected high quality assets for the purpose of securitization leaving behind low grade assets.
- Co-mingling Risk : The risk that the cash flow from securitized assets merging or mingling with other cash flows of the originator
- Credit Enhancement : A mechanism by which the credit rating of the packaged pool of assets is improved. This can be achieved through provision of bank guarantee / security bond, formation of a cash collateral account, creating a reserve fund, arranging a liquidity provider, getting a letter of credit or by getting credit insurance ( credit default swap), besides the more common form of credit enhancement through over collateralization



- Pass Through : SPV makes payments to the investors on the same periods and subject to the same fluctuations as are actually received
- Pay Through : SPV pays on stipulated dates irrespective of collection dates and amount actually collected or likely to be collected.
- SPV: A conduit or pass through organization or corporation created for limited purpose or life. A qualified SPV (SPV) is an entity which maintains an arm length relationship with the originator. A SPV can be a company, trusty or a mutual fund / AMC.



- Structural Credit Enhancement : A technique of credit enhancement by creation of senior and junior securities, thereby enhancing the credit rating of the senior securities.
- Over-collateralization : A form of credit enhancement in which the originator transfers extra collateral to the SPV to serve as security in the event of delinquencies
- Waterfall : Cash flow streams, in a structured credit enhancement process, which are shared by senior, junior and equity class of investors in order of priority. Sometimes cash flow streams are segregated as interest only received during the life of the deal and principal only category received on maturity.