

# *Securitization of Debt*

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## **Securitization Defined**

Securitization of debt, or asset securitization as is more often referred to, is a process by which identified pools of receivables, which are usually illiquid on their own, are transformed into marketable securities through suitable repackaging of cashflows that they generate. Securitization, in effect, is a credit arbitrage transaction that permits for more efficient management of risks by isolating a specific pool of assets from the originator's balance sheet. Further, unlike the case of conventional debt financing, where the interest and principal obligations of a borrowing entity are serviced out of its own general cash flows, debt servicing with asset-backed securities (ABS) is from the cash flows originating from its underlying assets.

## **What can be Securitized?**

In concept, all assets generating stable and predictable cash flows can be taken up for securitization. In practice however, much of the securitised paper issued have underlying periodic cashflows secured through contracts defining cash flow volumes, yield and timing. In this respect, securitization of auto loans, credit card receivables, computer leases, unsecured consumer loans, residential and commercial mortgages, franchise/royalty payments,

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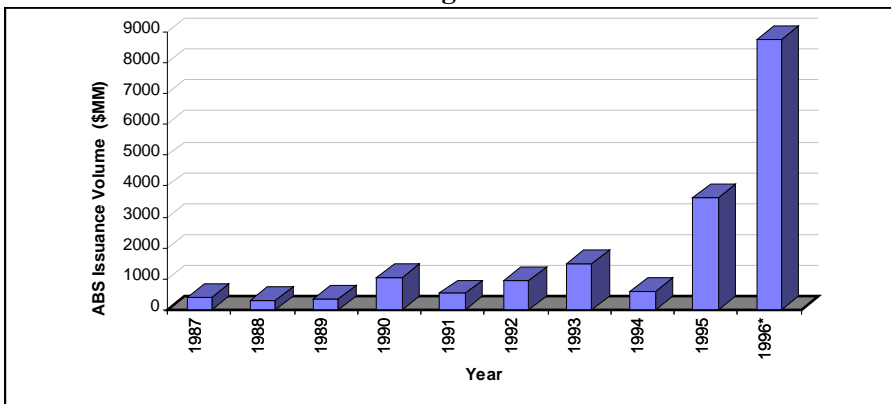
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and other receivables relating to telecom, trade, toll road and future export have gained prominence. Typically, asset portfolios that are relatively homogeneous with regard to credit, maturity and interest rate risk could be pooled together to create a securitization structure. However, to make reasonable estimates of the credit quality and payment speed of the securitised paper, it would be essential to analyse the historical data on portfolio performance over some reasonable length of time.

### Why Securitize?

Securitization effort will call for considerable investments in time and resources. Hence, on a comparative cost scale it can even be somewhat more expensive than other types of debt financing that may be available to a borrower, at least in the initial stages. However, it has been demonstrated that a continuing securitization program rather than a single deal often goes to reduce the costs, as economies of scale and expertise pick up over a period of time. Bearing this in mind, many securitization programs are run with a long-term strategic perspective. Growing importance of securitization is perhaps best illustrated by the volume through-put in the non-OECD world over the past few years (vide. Fig.1). Criteria that constitute the general motivation behind most securitization efforts are examined.

Fig. 1



\* Upto October 1996

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From the viewpoint of an originator of such paper, the following are typically the main persuasions to securitize.

- *Funding alternative*

Being distinct and different from the originator's own obligations, a well structured ABS stands on its own credit rating and thus generates genuine incremental funding. This is so as the originator's existing creditors may invest in the ABS in addition to providing lines of credit to the originator. Further, there may also be other investors in the ABS who do not have a lending relationship with the originator.

It is also possible to achieve a superior credit rating for the ABS than the originator's own through appropriate structuring and credit enhancement. This could mean accessing an investor base focusing on high grades, which otherwise may not be possible for an originator. Also, where the originator is not permitted to issue capital market instruments on his own ABS could help overcome such constraints.

- *Balance sheet management*

Fundamental benefit of a true sale, i.e., freeing up the capital of the originator would apply in the case of all securitization transactions. In response, the balance sheet gets compressed and becomes more robust. Its ratios improve. Alternately, reduction in leverage post-securitised sale can be restored by adding on new assets to the balance sheet. Thus the asset through-put of the originator's balance sheet increases.

Securitization can also generate matched funding for balance sheet assets. Further, it may also enable the disposal of non-core assets through suitable structuring.

- *Re-allocation of risks*

Securitization transfers much of the credit risk in the portfolio to the ABS investors and helps to quantify the residual credit risk that the originator is exposed to. This is very useful, as the originator can then take larger exposure to individual obligors as well as provide a higher degree of comfort to his creditors.

Securitization also transfers the originator's market risks, i.e., liquidity, interest rate and prepayment risks, to ABS investors and reduces risk capital

requirement. This can lead to more competitive pricing of the underlying asset products.

- *Operating process efficiency*

The extent of portfolio analysis and information demanded by securitization programs often lead to serious re-examination and consequent re-engineering of operating processes within the originator organisation. Further, specialist handling of various functional components, such as origination, funding, risk management and administration, often achieved through outsourcing, promotes efficiency across operating processes.

- *Securitization improves operating leverage*

The originator usually assumes the function of the servicer, the issuing and paying agent, and sometimes that of the credit enhancer. Fees accrue on account of all of these. Excess servicing, i.e., the difference between the asset yield and the cost of funds, is also normally extracted by the originator. These income streams can push up the operating leverage of the originator generating income from a larger asset base than what may be otherwise possible for a given capital structure.

Apart from the incentives that it offers to originators, ABS confer several benefits to its investors as well. These include:

- *Low event risk*

The pool of assets representing the obligations of a number of entities is usually more resilient to event risks than the obligations of a single borrower – i.e. the risk that the credit rating of the security will deteriorate due to circumstances usually beyond the obligor's control is much higher in the latter case. The diversity that the securitization pool represents makes the ABS largely immune to event risks.

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- *Higher yields for lower/similar risk*

ABS usually offer higher yields over securities of comparable credit and maturities. The yield spread typically represents the premium paid to compensate for prepayment risk, amortizing cashflows and the uniqueness of the instrument. In some cases, ABS also provide an opportunity to invest into a pool of otherwise illiquid and inaccessible assets.

- *Structured issuances*

Through appropriate structuring, an ABS can be tailored to meet investor standards on credit quality, yield and maturity. Working with a pool of receivables gives the originator the needed flexibility to be able to offer investors a menu of options around which issuances could be made.

- *Secondary Market Liquidity*

Investment decisions of institutional investors accord a sizeable weightage to instrument liquidity. ABS does fit the requirement in this regard. While the ideal scenario would be to have an active secondary market trading in ABS, institutional investors are often willing to settle for credible liquidity backstops provided by well-rated institutions.

## Parties in a Securitization Transaction

Securitization programs usually involve several participants, each carrying out a specialist function, such as, creating and analysing the asset pool, administration, credit rating, accounting, legal negotiation, etc. These include:

- The Originator – also interchangeably referred to as the Seller – is the entity whose receivable portfolio forms the basis for ABS issuance,
- Special Purpose Vehicle (SPV), which as the issuer of the ABS ensures adequate distancing of the instrument from the originator,
- The Servicer, who bears all administrative responsibilities relating to the securitization transaction,
- The Trustee or the Investor Representative, who act in a fiduciary capacity safeguarding the interests of investors in the ABS,

- The Credit Rating Agency, which provides an objective estimate of the credit risk in the securitization transaction by assigning a well-defined credit rating,
- The Regulators, whose principal concerns relate to capital adequacy, liquidity, and credit quality of the ABS, and balance sheet treatment of the transaction,
- Service providers such as Credit Enhancers and Liquidity Providers, and,
- Specialist functionaries such as legal and tax counsels, accounting firms, pool auditors, et al.

However, more important than all the aforementioned are the investors in the securitised paper. Investors are the ultimate judges of any securitization effort. Originators should therefore interact actively with the investor community to get to know investor preferences and concerns for effective structuring and distribution of ABS. Such knowledge would also make the origination process more efficient.

Further, it shall always be remembered that investors have their constraints in the form of legal restrictions, complexity of credit analysis, house name limits, long response time for in-house approvals, etc., all of which can block a deal, and more so in the case of ABS, which, on account of their uniqueness and complexity, present a host of issues which are not normally encountered, say in a straightforward bond investment.

### **Securitization Process**

Essential features of a securitization transaction comprise the following:

#### *1. Creation of asset pool and its sale*

The originator/seller (of assets) creates a pool of assets and executes a legal true sale of the same to a special purpose vehicle (SPV). An SPV in such cases is either a trust or a company, as may be appropriate under applicable law, setup to carry out a restricted set of activities, management of which would usually rest with an independent board of directors.

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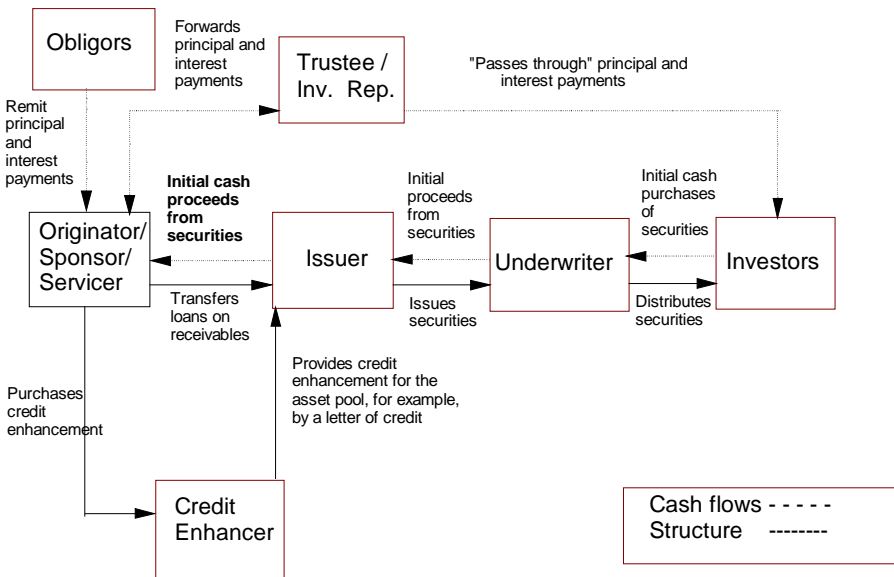
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### 2. Issuance of the securitised paper

This activity is usually performed by the SPV. Design of the instrument however would be based on the nature of interest that investors would have on the asset pool. In the case of pass-through issuances, the investors will have a direct ownership interest in the underlying assets, while pay-throughs are debt issued by the SPV secured by the assets and their cash flows.

### 3. Credit Risk

It must be made abundantly clear at the very outset that the accretions on the asset-backed security, i.e., interest, amortisation and redemption payments, are entirely dependent on the performance of the pooled assets, and will have nothing to do with the credit of the originator. By the same argument, such cash flows would also be not influenced by events affecting the condition of the originator, including insolvency.



#### 4. *Pool Selection*

The process of selecting assets to build a securitization pool would take into careful consideration, loan characteristics that are important from a cash flow, legal, and credit points of view, such as type of asset, minimum and maximum loan size, vintage, rate, maturity and concentration limits (geographic, single-borrower, etc.). 'Cherry-picking' to include only the highest quality assets in the pool should be consciously avoided. Ideal selection would be a random choice among assets conforming only to cash flow or legal criteria. Often, substitution of eligible assets in the place of original assets that mature/prepay in order to maintain the level of asset cover would also be required.

#### 5. *Administration*

Formal delineation of duties and responsibilities relating to administration of securitised assets, including payment servicing and managing relationship with the final obligors must be spelt out clearly through a contractual agreement with the entity who would perform those functions.

In addition, the following features are often included as part of a securitization transaction:

- Credit enhancement to support timely payments of interest and principal and to handle delinquencies,
- Independent credit rating of the securitised paper from a well known credit rating agency, and,
- Providing liquidity support to investors, such as appointment of market makers.

### **Documentation**

In documentation lies the heart of all securitization. An appropriate set of documentation, perfected against the applicable legal framework, is fundamental to structuring transactions. While the specifics may vary from one jurisdiction to another, there is a generic body of documentation that is normally applicable in most cases.

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Legal opinions constitute the very foundations. These must provide clear affirmation on all things fundamental, such as the legality of the transaction, the bankruptcy remoteness of the issuer from the originator, the issuer's authority to enter into such transactions, the legal true sale of receivables to the issuer, the creation of security over the receivable pool, etc.

Other documentation relate to receivables, security, administration and operational aspects. Receivable documentation should first establish the existence and nature of underlying obligations, such as payment schedules, the conditions under which the obligors may either renege or repudiate payments, and terms of sale of such receivables. It must also confirm that the receivables have been originated in compliance with the applicable statutes. When receivables are sold, documentation specifying the items sold, the mechanics of sale and the representations and warranties made by the seller on their characteristics would be drawn up. Further, the claims of investors in ABS over such flows need to be established clearly through the security documentation.

Service documentation specifying the duties and responsibilities of the servicer or servicing agent would also be a key one. In practice, originators often double up as servicers. Related documentation in addition to the above would typically comprise those relating to credit enhancement, liquidity and market-making, listing agreements with stock exchanges, as well as transaction prospectus or information memoranda, as may be appropriate.

### **Structuring Considerations**

These are fundamental to every securitization deal, as they determine the specifics relating to the ABS instrument, the issuer, the relevant tax and accounting treatment, and other key factors. Every ABS issuance may have to be structured differently in order to take the best advantage of the various environmental factors.

First of the structuring decisions would concern the manner in which the pool of assets will be sold/transferred. This would be followed by the design of the ABS instrument, as either a pass through or a pay through security. Pass-throughs represent direct ownership interests in the

underlying assets, which are typically held in trust for the investors, so that payments on the assets are passed through to the investors directly from the assets (after payment of all fees and expenses, including excess servicing). Pay throughs, on the other hand, are general obligations or preferred stock of the issuer (SPV), substantially all the assets of which consist of a pool of receivables and the related credit enhancement or other structural support. As the assets are owned by this entity rather than the investors, who as a matter of law receive payments on a separate security backed by the general credit of the entity rather than an interest in the assets, payments on these assets are said to be paid rather than passed through to the investors.

Tax and accounting treatments constitute other important dimensions of structuring. Typical tax issues that need to be addressed relate to transfer charges (stamp duty), capital gains taxation as applicable to the originator on sale of assets, taxation of the issuer, and withholding tax or taxes deducted at source as applicable to the issuer and the investors.

Accounting treatment of securitization could fall into one of the following three categories, viz., full derecognition, partial derecognition where only transferred assets receive derecognition, and full on-balance sheet recognition. Specialist opinion must be obtained on both tax and accounting aspects. These would be environment specific.

Credit enhancement of the ABS would also be an important structuring consideration, as it strives to strike a balance between the investor and the issuer needs on the credit quality of the instrument. Typical forms of credit enhancement include: Spread Account or Reserve Account, Over-collateralisation, Letters of credit, Insurance company guarantees, Senior/Subordinated structure, etc.

Other structuring issues that need to be addressed relate to extraction of excess servicing, identification of payment and loss priorities, etc.

### **Securitization in the Indian Context**

Over the past five years or so (ending 1996), an estimated Rs.700 crores of asset-backed securities have been issued in the Indian market. This figure

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includes issuances of some high quality securitised paper structured largely in line with international standards. Bulk of the ABS issued in India have been backed by auto loan receivables. Securitizing property developer receivables has also been attempted. Securitization involving credit cards, mortgages, and future receivables are yet to make their appearance, as the currently applicable legal framework is not supportive in this regard.

Much of the securitization effort in the country has thus far been spearheaded by one commercial bank, in collaboration with one credit rating agency. As part of its efforts to develop the ABS market, the bank had acted both as originator and investor in ABS. However, of late, some investors have emerged from the mutual funds and insurance sectors, although their level of interest at present seems limited. The market for ABS has been stagnant largely for want of a suitable enabling regulatory framework.

### **Why is Securitization Relevant in the Indian Context?**

In the Indian context, the benefits that securitization can bring about can be quite significant. The following merit consideration in this regard. In a capital-short economy, an opportunity that permits effective use of available capital hardly requires any major emphasis. In addition, the ability to diversify one's funding base by reaching out to new investor markets, without increasing the financial leverage, which may otherwise have regulatory implications in some cases, is also of definite value. Obtaining matched funding leading to effective balance sheet management is particularly significant from commercial banks' perspective. Reallocating risks in a planned and transparent manner helps in managing them better. Originators would also stand to benefit on account of possible gains that would accrue in the form of improvements in their credit and operating processes, as these come under detailed scrutiny.

Given the length of credit history available within the Indian banking system, it is possible to originate substantial volumes of ABS of credit quality consistent with the rating required. This would ensure continuous supply of assets that can be tailored to meet the credit appetites of investors. Institutional investors may not only benefit from such customised

issuances, but also may have access to invest into otherwise illiquid assets at superior yields without compromising on their credit standards.

In the medium to longer term, the securitization process could upgrade the level of sophistication of banking and finance in the country. This, combined with an appropriate regulatory framework, can make securitization an important catalyst in mobilising domestic savings as well as attracting foreign capital, which can be of immense value, particularly in the context of capital requirements to develop the country's infrastructure sector. Securitizing project finance, telecom, toll road and other similar receivables could well become reality in the medium term future.

### **What Needs to be Done?**

Several factors have led to the development of global ABS markets. It is perhaps useful to draw inspiration from those successes and evaluate if some of those factors, if not all, apply in the Indian context. Principal factors that have spurred the development of ABS markets in the OECD (mostly the U.S.) world include:

- Competitive pressures released due to deregulation, forcing sharp declines in bank lending margins,
- Successive financial sector crises (some of which may actually be attributable to credit quality dilution on account of fierce competition) leading to sectoral level credit deterioration,
- Universal adoption of capital adequacy standards, with efficiency of capital usage increasingly becoming the basis of evaluating banks and financial institutions,
- Increasing functional specialisation leading to large scale outsourcing,
- Giant strides in information technology,
- Global trend towards making all debt issuances in tradable form, and, most importantly,

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- The patronage (including credit support) of national governments by enacting supportive legislation, setting up specialized agencies to provide credit enhancement, etc.

A closer evaluation would confirm much of these factors do apply to the Indian financial system, more so at present in an era of economic liberalization, than before. Deregulation, shrinking margins, capital adequacy are all here to stay, and the benefits of progress in information technology are as much available to India as they are to other countries. Given all these, one may perhaps think that an enabling legal framework and institutional support from the government and its agencies could form the necessary foundations from which an active ABS market could emerge in this country.

Recognizing that ultimately it is the investor who determines success in this regard, it is worthwhile to examine first as to what regulatory changes are needed from an investor perspective. All over the world, large fixed income investors, such as insurance companies and pension/provident funds, are the natural choices for distributing ABS. However, in the current scenario in India, the list of instruments permitted for investment by such entities does not include ABS. In fact, a legal definition for ABS does not even exist at present. Hence, it would be ideal to firstly define ABS as a security under the Securities Contracts Regulation Act. As the next logical step, appropriately rated ABS may be ranked on par with debentures through a suitable umbrella definition of fixed income securities. This would simplify operational aspects relating to ABS, such as listing on the exchange, as its treatment would then be similar to that of a debenture. The ABS instrument may then become available for investment by insurance companies and registered FIIs.

Rated ABS may also be permitted for investments by provident funds, pension funds, et al. In the case of institutions that come under mandated sectoral asset allocations, ABS backed by receivables from such of those sectors may be permitted as acceptable equivalents. For example, a mortgage pass through may be treated as equivalent to providing housing finance.

For the longer term viability of securitization, it is vital to broaden the investor base to include sophisticated fixed income investors. Opening up

insurance and pension fund sectors would be natural choices in this regard, although it appears at this juncture that the required changes in legislation towards this purpose will have to wait for a while.

The next set of legislative changes concern stamp duty on transfers and the taxation of the issuer. The law should be able to distinguish between revolving and non-revolving asset-backed structures and charge a uniform level of stamp duty. In other words, in the case of revolving asset securitization such as credit cards, replacement assets ideally should not be subject to stamp duty. In such cases, the law should also provide a methodology for defining proportionate interest. Further, it is also important to rationalise stamp duties at least for the purpose of securitization across the various states.

The issuer (SPV) shall be given a tax status similar to grantor trusts under U.S. law. i.e., the special purpose entity used in pass-throughs, the income of which is not taxed at the entity level, but at the level of the beneficiaries of the entity; the beneficiaries in this case being the investors who hold the ABS issued by the entity. This may be achieved by according securitization SPVs, a tax treatment similar to that of mutual funds. At the initial stages, adequately capitalised banks may be allowed to set up such vehicles.

Further, setting up of a banking matters tribunal on the lines of consumer courts could also be of help in expeditious enforcement of security interests and consequently facilitate the development of ABS market. The fact that setting up of such tribunals will also help the banking industry in general is of course an equally important aspect.

Other than the legal and regulatory changes required, securitization efforts should also cater to some specific preferences of investors if they were to succeed. As the ABS market is only at its beginnings at present, it is perhaps not unjustified for investors to ask for a high level of credit enhancement that is easily visible and understood, i.e., an 'iron clad' guarantee of sorts. While the economics of catering to such an investor preference will have to be evaluated, it may perhaps be the way to start the ABS market, possibly with some assistance from the government, not much

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unlike the way GNMA pass throughs started in the USA. Yields on such paper may be kept tight initially and once the investor awareness and the level of comfort with the instrument increases, such credit enhancements may be made selective or phased out.

Indian institutional investors also have a preference for liquidity in the ABS instrument. This preference exists more in the nature of a liquidity backstop rather than a demand for an active secondary market. A liquidity backstop facility is ideally provided by a credible entity working on a transparent benchmark. The facility also needs to be formalised through appropriate documentation. Support from a Government agency or an institution of repute would be of considerable value in this regard.

In addition to such preferences, institutional investors such as mutual funds also require reliable valuation benchmarks on ABS in order to evaluate their portfolio performance. Until the ABS market reaches a certain critical volume and level of activity, market maker quotations would be hard to come by. The aforesaid liquidity facility may therefore act as a surrogate valuation benchmark in the interim.

## **Conclusion**

As has been demonstrated in the case of several developed financial markets, asset securitization is an important building block in creating an efficient and broad-based financial system. The concept is highly relevant to emerging economies, given their capital constraints. An enabling policy framework and affirmative actions in this regard from the government can immensely facilitate the development of the asset-backed securities market in India.

From an originator viewpoint, longer term advantages of securitization are that, if used strategically, it will enable them both to grow and to create a sustainable competitive advantage. The growth will come from the funding flexibility it can provide, as the balance sheet will be less of a constraint and the demand for regulatory capital will be proportionately lower.

From a developmental perspective, it is absolutely vital to develop the domestic debt capital markets in the country in order to mobilise longer term savings. While pension funds, insurance companies, et al, may

function as agencies of such resource mobilisation, it is important to create a range of high quality financial assets into which they can invest. These assets can in turn direct the mobilised resources to their appropriate destinations in the larger interests of the nation. Securitised debt backed by receivables from infrastructure financing may well be one category of such assets which could satisfy this requirement. Further, the ninth five year plan estimates the volume of resource requirements in the housing and infrastructure sectors to be of the order of Rs.150,000 crores and Rs.200,000 crores respectively. Such staggering numbers should only persuade speedier development of securitization in the country.