

SECURITISATION— AN OVERVIEW



Securitisation has emerged as a key word in the world of finance. In a generic sense, the securitisation is basic to the world of finance and it can be said that it envelops the entire range of financial instruments, and hence, the entire range of financial markets. Read on to have an insight into various issues involved.

—Rajkumar S Adukia

In theory, a loan is a simple transaction. A borrower wants money, and a lender offers it and collects interest: this arrangement continues until the loan is repaid. In some cases, however, the borrower may be unable or unwilling to pay back the loan. Secured loans, where the borrower offers collateral such as real estate or machinery, are supposed to cater to just such contingencies. In case of a default, creditors can seize and sell the asset to recover their money.

This neat concept breaks down if the seizure of an asset is impossible within reasonable time limits – as has been the case in India. A tardy legal system makes it virtually impossible to seize the assets of defaulters. Endless hearings and appeals keep things in limbo for

decades; borrowers can afford to ignore creditors' demands and pay the legal fees instead.

As a result, there are bad debts across the entire financial system. These drive up the cost of loans and ruin the lenders' financials. Banks and financial institutions write off huge sums each year to cover bad debts. Estimates of the size of these “non-performing assets” – bankers' jargon for bad debts – vary from Rs 85,000 crore to twice as much.

What is securitisation

Securitisation is the process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that can be sold to investors. Securitisation has emerged as an important means of financing in

recent times. A typical securitisation transaction consists of the following steps:

- ✎ Creation of a special purpose vehicle to hold the financial assets underlying the securities;
- ✎ Sale of the financial assets by the originator or holder of the assets to the special purpose vehicle, which will hold the assets and realize the assets

Issuance of securities by the SPV, to investors, against the financial assets held by it. This process leads to the financial asset being taken off the balance sheet of the originator, thereby relieving pressures of capital adequacy, and provides immediate liquidity to the originator.

Need for securitisation

The generic need for securitisation is as old as that for organised financial markets. From the distinction

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between a financial relation and a financial transaction earlier, we understand that a relation invariably needs the coming together and remaining together of two entities. Not that the two entities would necessarily come together of their own, or directly. They might involve a number of financial intermediaries in the process, but nevertheless, a relation involves a fixity over a certain time. Generally, financial relations are created to back another financial relation, such as a loan being taken to acquire an asset, and in that case, the needed fixed period of the relation hinges on the other, which it seeks to back-up.

Financial markets developed in response to the need to involve a large number of investors in the market place. As the number of investors increases, the average size per investors comes down - this is a simple rule of the market-place because growing size means involvement of a wider base of investors. The small investor is not a professional investor: he is not as such in the business of investments. Hence, he needs an instrument which is easier to understand, and is liquid. These two needs set the stage for evolution of financial instruments which would convert financial claims into liquid, easy to understand and homogenous products, at times carrying certified quality labels (credit-ratings or security), which would be available in small denominations to suit every one's purse. Thus, securitisation in a generic sense is basic to the world of finance, and it is a truism to say that securitisation envelopes the entire range of financial instruments, and hence, the entire range of financial markets.



Parties involved

Securitization programmes 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 Asset Backed Security (ABS) issuance.
- **Special Purpose Vehicle (SPV)**, which as the issuer of the ABS ensures adequate distancing of the instrument from the originator.
- **The Investors** – The investors may be in the form of Individuals or institutional investors like FIs, mutual funds etc. They buy a participating interest in the total pool of receivables and receive their payment in the form of interest and principal as per agreed pattern.

Other parties

- ✚ **The obligor** is the originator's debtor (borrower of the original loan).
- ✚ **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.

Securities issued by Special Purpose Entity

1. Asset backed Securities
2. Mortgage backed Securities

Securities issued by SPV in a securitisation transaction are referred to as Asset Backed Securities (ABS) because investors rely on the performance of the assets that collateralise the securities. They do not take an exposure either on the previous owner of the assets (Originator) or the entity issuing the securities (the SPV).

In practice a further category is identified – securities backed by mortgage loans (loans secured by specified real estate property, wherein the lender has the right to sell the property, if the borrower defaults). Such securities are called Mortgage Based Securities (MBS). The most common example of MBS is securities backed by mortgage housing loans.

Let us take the example of National Housing Bank and see how the whole process of home loans receivables works. Home rental receivables, once securitisation takes off, will work in much the same manner as this.

- Let us first take a look at the role that **housing finance companies** (HFCs) are going to play. The HFCs will be called mortgage originators and they will be responsible for assessing loans, which are good and worthy of being converted into mortgages. In this case, the HFCs involved are HDFC and LIC Housing Finance.
- Now these HFCs will pass on the mortgages to a **Special Purpose Vehicle**, (SPV) which is NHB in this case. This means the loans will move from the books of the HFCs to the SPV. The SPV will be responsible for pooling together the loans received from HFCs into securitized instruments, called mortgage backed securities (MBS). The SPV will in turn, pay upfront cash to the HFC for the loans received. The HFC can use this fund to generate more mortgages. It will be the responsibility of the SPV to see that receivables of similar maturities, rate of interest etc. are pooled together while forming the securitized instrument.
- The third player in this game will be **the investor**, who will subscribe to the mortgaged securities (MBS). The MBS will be like an interest bearing bond or debenture and through the sale of this instrument, the SPV will get back the amount spent on acquisition of the loans. And how does the investor of the mortgaged security get paid?

Investors will get paid through the money received in the form of loan repayments by those borrowing home loans through HFCs. HFCs are in turn paid certain service charges by the SPV for the servicing of the loan.



Credit Enhancement

It refers to any of the various means that attempt to buffer investors against losses on the assets collateralising their investment. There are following types of credit enhancements:

- **External Credit enhancements:** Letter of credit, Third party guarantee and Insurance are the types of external credit enhancements.
- **Internal Credit enhancements:** Credit trenching, Over-collateralization, Cash collateral, spread account and Triggered amortisation are types of internal credit enhancements.

Securitisation Act

The Securitisation And Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) is a mix of three different things - Securitisation, Asset management companies and enforcement of security interests on loan defaults to banks. The basic intention behind this act is to strengthen creditor rights through foreclosure and enforcement of securities by banks and financial institutions. By conferring on lenders the right to seize and sell assets held as collateral in respect of overdue loans, it

allows banks and financial institutions to recover their dues promptly without going through a costly and time-consuming legal process. The Act contains VI chapters and 42 sections:

Chapter I – Preliminary Short title and commencement

- (1) This Act may be called the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.
- (2) It extends to the whole of India.
- (3) It may come into force on the 21st day of June 2002.

Chapter II - Regulation of Securitisation & Reconstruction of Financial Assets of Banks & Financial Institutions

- The Securitisation will be done through a new/existing company, which must have minimum paid up capital of Rs. 2 crores.
- Existing Securitisation companies have to comply with the new regulation within next 3 months till which time they will be allowed to carry on business of Securitisation.
- Securitisation companies who are registered with RBI cannot make substantial change in the

management or location etc without prior approval of RBI. They are not allowed to carry on any other business activities except that of Securitisation & Reconstruction of Assets. The expression “substantial change in management” means the change in the management by way of transfer of shares or amalgamation or transfer of the business of the company.

- The Reserve Bank may cancel a certificate of registration granted to a securitisation company or a reconstruction company, if such company—
 - (a) ceases to carry on the business of securitisation or asset reconstruction; or
 - (b) ceases to receive or hold any investment from a qualified institutional buyer; or
 - (c) has failed to comply with any conditions subject to which the certificate of registration has been granted to it; or
 - (d) at any time fails to fulfil any of the conditions referred to in clauses (a) to (g) of sub-section (3) of section 3; or
 - (e) fails to
 - (i) comply with any direction issued by the Reserve Bank under the provisions of this Ordinance; or
 - (ii) maintain accounts in accordance with the requirements of any law or any direction or order issued by the Reserve Bank under the provisions of this Ordinance; or
 - (iii) submit or offer for inspection its books of account or other relevant documents when so demanded by the Reserve Bank; or



The new Act – Securitisation & Reconstruction of Financial Assets & Enforcement of Security Interest w.e.f 21.06.2002 allows secured lenders to sell or lease assets, which are charged with them by defaulting borrower (classified as NPA) without protracted legal tussle.

- A Securitisation company or reconstruction company may raise funds from the qualified institutional buyers by formulating schemes for acquiring financial assets and shall keep and maintain separate and distinct accounts in respect of each such scheme for every financial asset acquired out of investments made by a qualified institutional buyer and ensure that realisations of such financial asset is held and applied towards redemption of investments and payment of returns assured on such investments under the relevant scheme.
- Any securitisation company or reconstruction company registered under section 3 may
 - (a) act as an agent for any bank or financial institution for the purpose of recovering their dues from the borrower on payment of such fees or charges as may be mutually agreed upon between the parties;
 - (b) act as a manager referred to in clause (c) of sub-section (4) of section 13 on such fee as may be mutually agreed upon between the parties;
 - (c) act as receiver if appointed by any court or tribunal:

Chapter III – Enforcement of Security Interest

- The new Act – Securitisation & Reconstruction of Financial Assets & Enforcement of Security Interest w.e.f 21.06.2002 allows secured lenders to sell or lease assets, which are charged with them by defaulting borrower (classified as NPA) without protracted legal tussle.
- ‘Non-performing Assets’ means an asset or account of a borrower, which has been classified by bank or financial institution as sub-standard, doubtful or loss asset, in accordance with the directions or guidelines relating to the asset clarification issued by RBI.
- The Act overrides some of the provisions of the Companies Act, 1956 as well as the Transfer of Property Act.
- The Act requires 60 days notice to be given to the defaulter. The notice has to be very specific about defaulted amount.
- On receiving the notice, no borrower can sell, lease or transfer the secured assets mentioned in the notice, without the lenders consent.
- Bankers can act, even on those cases that are pending with the BIFR, provided more than 75% of such secured creditors agree to the same.
- No fresh reference shall be made to BIFR after commencement of this Act where financial assets have been acquired under this Act. Now of course SICA i.e. BIFR has been repealed w.e.f. 01.01.2004 and the SICA (special provisions) Repeal Bill will become effective after notification.

tion in official gazette.

- If borrower fails to respond to the notice by offering payment, the security lender at his discretion can take any of the following actions:
 - (a) Take possession of the assets mortgaged and transfer the same either by selling or by leasing.
 - (b) Takeover the management of the Secured Assets of the defaulting borrower.
 - (c) Can appoint manager to take charge of secured assets taken into possession.
- If there are more than one secured creditors, the decision to make provisions of this Act will be made applicable only when 75% of them are agreeable.
- In the event of the total dues of the secured creditors are not recovered from sale of secured assets, they will have right of approaching DRT for recovery



of balance amount from the borrowers/guarantors.

- Chief Metropolitan Magistrate or District Magistrate will assist the secured creditors on request being made to them.
- No injunction shall be granted by any civil court or other

The Supreme Court, in its judgement in case of Mardia Chemicals Ltd. and Others vs. Union of India and Others upheld the constitutional validity of SARFAESI Act but struck down Sub-Section (2) of Section 17 which provides for deposit of 75% of claimed amount before appeal is admitted by DRT

authority in respect of action taken under this Act.

Rights of the borrower

A borrower can object to the measures taken under this Act within 45 days subject to condition of depositing 75% of the amount outstanding with DRT, or lower amount if approved by DRT.

If at appeal level, it can be established that the possession of secured assets by the secured creditor was wrongful then DRT/Appellate tribunal will direct the secured creditor to return such secured assets to the concerned borrower.

Limitation as prescribed under Limitation Act, 1963 will be applicable even to this Act.

Borrowers can also apply to the State Government in Maharashtra and Gujarat for relief under, Bombay Relief Undertaking Act. The stay against Securitisation proceedings may be granted on a case-by-case basis on merits. Normally, it will be decided by Industries Minister or Chief Minister, though very few instances have been witnessed for such relief at present. The relief is

normally given for 1 year.

Chapter IV— Central registry

- The Central Government may, by notification, set up the Central Registry with its own seal for the purposes of registration of transaction of Securitisation and reconstruction of financial assets and creation of security interest.
- The central government may also notify the territorial limits within which an office of a Central Registry may perform.
- The central registrar is to be informed within 30 days of any Securitisation transaction, asset reconstruction or security interest.
- The particulars of Securitisation or reconstruction or security interest entered in the Central Register of such transactions kept under section 22 shall be open during the business hours for inspection by any person on payment of such fees as may be prescribed.

Chapter V— Offences and Penalties

If a default is made;

- (a) in filing under section 23, the particulars of every transaction of any Securitisation or asset reconstruction or security interest created by a Securitisation company or reconstruction company or secured creditors; or
 - (b) in sending under section 24, the particulars of the modification referred to in that section; or
 - (c) in giving intimation under section 25,
- Every company and every officer of the company or the secured creditor and every offi-

cer of the secured creditor who is in default shall be punishable with fine that may extend to five thousand rupees for every day during which the default continues.

- If any Securitisation company or reconstruction company fails to comply with any direction issued by the Reserve Bank under section 12, such company and every officer of the company who is in default, shall be punishable with fine which may extend to five lakh rupees and in the case of a continuing offence, with an additional fine, which may extend to Rs. 10,000 for



every day during which the default continues.

- If any person contravenes or attempts to contravene or abets the contravention of the provisions of this Ordinance or of any rules made thereunder, he shall be punishable with imprisonment for a term which may extend to one year, or with fine, or with both.
- No court inferior to that of a Metropolitan Magistrate or a Judicial Magistrate of the First Class shall try an offence punishable under this Ordinance.

Chapter VI – Miscellaneous

ARC's accounting must be in consonance with the relevant Accounting Standards and Generally Accepted Accounting Principles. There is a specific requirement to the effect that income on any recoveries on an NPA should be only on cash basis

The provisions of this Act shall not apply to

- Alien on any goods.
- A pledge on movable property.
- Creation of any security in an Aircraft.
- Creation of any security interest in any vessel.
- Any conditional sale, hire purchase or lease or any other contract in which no security interest is created.
- Any right of unpaid seller under Section 47 of the sale of Goods Act. Any property not liable to attachment.
 - Any security interest for repayment of any financial asset not exceeding one lakh rupees.
 - Any case in which the amount due is less than 20% of the principal amount and interest thereon.
- Any security interest created on agricultural land.

Benefits of Securitisation

- **Liquidity:** Selling a portfolio results in availability in ready cash.
- **Raise cheaper funds:** Experience in the US and Europe shows that Securitisation is a cheaper form of raising finance for the originator than the traditional forms of debt financing.
- **Convert of Marketable Securities:** Assets such as personal loan, residential mort-

gages, credit card receivables, lease/hire receivables, which are not marketable in their original forms are converted into marketable securities.

- **Transfer of Risks:** Transfer of assets to a Special purpose Vehicle (SPV) results in transfer to all associated risks such as risk of default, currency risk and inherent risk.

RBI guidelines for Securitisation & ARC

The RBI guidelines cover the following aspects

1. Guidelines and directions covering the registration and operation of ARC.
2. Guidance notes in relation to the financing and accounting policies thereof.
3. Guidelines to the lenders in relation to transfer of financial assets to ARCs.

As per amendment (29.03.2004)

- Every Securitisation company or reconstruction company seeking the Bank's registration under Section 3, or carrying on business on commencement of the Securitisation Companies and Reconstruction Companies (Reserve Bank) (Amendment) Guidelines and Directions, 2004, shall have a minimum Owned Fund not less than fifteen percent of the total financial assets acquired or to be acquired

by the Securitisation Company or Reconstruction Company on an aggregate basis, or Rs. 100 crore, whichever is less; irrespective of whether the assets are transferred to a trust set up for the purpose of securitization or not.

- ❑ Further the Securitisation Company or Reconstruction Company should continue to hold this owned fund level until the realization of the assets and redemption of security receipts issued against such assets.
- ❑ The Securitisation Company or Reconstruction Company can utilize this amount towards the Security Receipts issued by the trust under each scheme. This will ensure the stake of the Securitisation Company or Reconstruction Company in the assets acquired.
- ❑ **No subsidiaries of Bank:** Some of the ARCs are currently being promoted by Bank and FIs. The shareholding of such ARCs are dispersed in such a manner that they do not become subsidiaries of any of the promoting institutions.
- ❑ **NPA to be taken over at proper price:** Care has to be taken in constituting the management structure and operations of the



CASES OF SECURITISATION

- ☞ Securitised deals have been taking place in India during last few years. Some of them are listed below
- ☞ First deal in India between Citibank and GIC Mutual Fund, in 1990 for Rs. 160 million.
- ☞ Securitisation of cash flow of high value customers of Rajasthan State Industrial and Development Corporation in 1994-95, structured by SBI cap.
- ☞ NHB-HDFC Securitisation deal of Rs. 597 million based on the receivables of 8330 housing loans in August 2001.
- ☞ Securitisation of overdue payments of UP government to HUDCO by issue of tax-free bonds worth Rs. 500 million
- ☞ NHB entered into a securitisation deal with HDFC, LIC Housing Finance, Canfin Homes and Dewan Housing.
- ☞ Securitisation of Sales Tax deferrals by Government of Maharashtra in August 2001 for Rs. 1500 million with a green shoe option of Rs. 75 million.
- ☞ First deal in power sector by Karnataka Electricity Board for receivables worth Rs. 1940 million and placed them with HUDCO.
- ☞ The second MBS transaction through HUDCO.
- ☞ Mega securitisation deal of Jet Airways for Rs. 16000 million through offshore SPVs.
- ☞ ILFC sponsored securitisation of receivables by Varun Shipping.
- ☞ Data indicate that ICICI had securitised assets to the tune of Rs. 27500 million in its books at end March 1999.
- ☞ Securitisation of lease receivables on power project by L&T

ARC such that even if the promoting bank or FIs transfer their NPA portfolio, then it will be treated as transfer to an independent or non-sub-sidiary ARC. Valuation of the NPA portfolio will have to be negotiated at arms length and upsides on recovery can be even shared with ARC.

- ❑ **NPA acquisition based on properly framed policies:**

Every ARC is required to have a “financial asset acquisition policy” which inter alia must lay down policies and guidelines for the valuation of NPAs acquired by the ARC (having realizable value and capable of being reasonably estimated and independently valued).

- ❑ **True sale and not adjustment:** The acquisition of financial assets by an ARC must conform to the principles of a “true sale”



- **Due Diligence:** Proper due diligence and NPA portfolio valuation before any transfers should be made by banks or FIs to the ARCs. This means that the pricing of NPA portfolio transfers will take place through a process of discovery, as in the case of a business acquisition.
- The provisions of paragraph 9 of the above guidelines and directions relating to maintaining on an ongoing basis, a capital adequacy ratio, which shall not be less than fifteen percent of the total risk weighted assets of the Securitisation Company or Reconstruction Company, shall be applicable.

Accounting for ARCs

As such, the ARC's accounting must be in consonance with the relevant Accounting Standards and Generally Accepted Accounting Principles. There is a specific requirement to the effect that income on any recoveries on an NPA should be only on cash basis.

The RBI guidelines essentially require that the ARC should account for the NPA portfolio (from a provisioning perspective) in the same way as required of a bank or FI.

Mardia Chemicals case

1. The Supreme Court, in its judge-

ment in the matter of Mardia Chemicals Ltd. and Others Vs Union of India and Others upheld the constitutional validity of the SARFAESI Act but struck down Sub-Section (2) of Section 17 which provides for a deposit of 75% of the claimed amount before the appeal is admitted by DRT. The Supreme Court also held that after the service notice, if the borrower raises any objection or places facts for consideration of the creditor, the same may be considered with due application of mind and the reasons for not accepting the objection must be communicated to the borrower. However, the borrower will be able to move the Secured Creditor has taken the DRT only after the possession of secured asset.

2. To bring the provisions of the Act in conformity with the Judgement of the Hon'ble Supreme Court Order, to dissuade the borrower from indulging in dilatory tactics with a view to postpone the repayment of dues and to enable secured creditors to make speedy recovery by enforcement of securities, **the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 has been amended by promulgation of the Enforcement of Security Interest and Recovery of Debt Laws (Amendment) Ordinance, 2004 (Ord. 5 of 2004) on 11.11.2004.**

3. The salient amendments are as under: (i) The Secured Creditor will be able to take possession of the secured assets only after reasons for not accepting the objections of the borrower have been communicated to him in writing. After possession of the secured

asset has been taken, the borrower can file an application before the DRT without any deposit. If the DRT does not dispose off the petition within four months, the borrower or the Secured Creditor can move the Debt Recovery Appellate Tribunal (DRAT) for directing the DRT for expeditious disposal of the application.

After the disposal of the case by the DRT the borrower, if aggrieved, can appeal to the DRAT with a deposit of 50% of the decreed amount or as determined by the DRT but not lower than 25%.

(ii) To confer power upon the Appellate Tribunal to transfer all pending applications before different DRTs to one DRT.

(iii) To empower RBI to call for periodic returns and information from Securitisation Companies and Asset Re-construction Companies.

(iv) To provide for taking over of management of the business of the borrower under Section 13(4). This was omitted in the original Act. Though Section 15 provides for the manner and effect of take over of management of business, Section 13(4) did not provide for taking over the borrower's business by the Secured Creditor.

4. Other amendments are of clarificatory and consequential nature.

Conclusion

The Act and the notice could be primarily used as a powerful bargaining tool while negotiating with the defaulter. This puts banks on stronger ground in salvaging sticky loans. The Banks will now have a clear edge in negotiations and also of recovering most of the dues particularly from willful defaulters. ■