Securitisation of Credit Exposures: Important Tool of Credit Risk Management under Basel Accord II

Securitisation, as a new Credit Risk Management Product, is the buzzword of the financial services industry today. As a matter of fact, following the age-old system of credit risk management may not always suit the regime of liberalisation, privatisation and globalisation in world economies. It is, therefore, required that banks/credit institutions should constantly devise newer forms of credit risk management by articulated research. Several key initiatives taken in this regard finally gave birth to securitisation of credit exposures by banks/credit institutions under Basel Accord II Risk Management in June 2004. This article provides an overview of the concept.

What is Securitisation?

Securitisation (of credit exposures of Banks and Credit Institutions) involves a transfer of outstanding balances in Loans/Advances and packaging into transferable and tradable securities. This enables them to reduce their exposures to particular sectors e.g. Real Estate as may be considered necessary from their business development angle and, simultaneously to ensure cash inflows to deal with liquidity crunch and/or for other business reasons.

Mr. Joel Telpner has succinctly defined securitisation as under:

"Securitisation is a financing tool. It involves creating, combining and recombining of assets and securities."

Basel Accord II has considered securitisation aspects in a broader perspective as: "A Traditional Securitisation is a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or trenches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures".

- SK Bagchi

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The Accord has also identified another variant of securitisation as 'Synthetic Securitisation,' which is akin to a Credit Derivative. In this regard it has been laid down that: "A synthetic securitisation is a structure with at least two different stratified risk positions to reflect different degrees of credit risk where credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of funded (e.g. credit linked notes) or unfunded (e.g. credit – default swaps) credit derivatives.

In the context of securitisation of Standard Assets, Reserve Bank of India has defined securitisation as "a process by which a single performing asset or a pool of performing assets are sold...". This sale has to be made to a special purpose vehicle and sold assets are to be removed from the Balance Sheet of the originating Bank.

In order to assess the utility of securitisation tool – both traditional and synthetic going by Accord guidelines, it may be necessary to look into the points of distinction as under:

Credit Derivative (Synthetic Securitisation)	Securitisation (Traditional)
1. This instrument has no effect on the underlying asset of the credit protection buyer (CPB) as the relative asset continues to be in his books.	It involves the full transfer of the loan/ investment assets concerned from the books of the party for offering securitisation.
2. It does not involve the acquisition of any financial assets.	It involves the acquisition of financial assets.
3. It applies to performing assets only (non-performing assets are generally excluded).	It applies to non-performing assets as well as performing assets.
4. It is an item of over-the-counter trade - unbundling credit risk from the credit instrument.	It is not an OTC trade item.
5. Sovereign risk can be hedged through credit derivatives.	The securitisation process does not generally involve sovereign risk.
6. Precondition for payment by credit protection seller (CPS) to CPB is the existence of any 'credit event' - bankruptcy, insolvency, default, etc.	No precondition, since the assets are fully transferred.
7. Documentation process is fairly standardised, involving nominal cost.	Transaction involves specific legal process and compliance, which often turns out to be quite expensive.

What is Credit Enhancement?

An important element of securitisation is in the form of credit enhancement. In the customary bank–lending practices, credit enhancement is understood to be an increment of credit amount (Limit) to a borrower e.g. from Rs. 1 lac say to Rs. 2 lacs and so on. But in the context of securitisation of exposures, credit enhancement has a different connotation. It has no reference of enhancement of credit limit at all. It simply means that when the securitised exposure has the comfort of any acceptable guarantee say Bank guarantee the same is to be known as Credit Enhancement.

Mr. Joel Telpner has provided a simplified version as under:

"An asset backed security is said to be 'Credit Enhanced' if there is some feature present in the transaction that makes it more likely that the holder of the security will receive payments when due."

Basel Accord II states that: "A credit enhancement is a contractual arrangement in which the bank retains or assumes a securitisation exposure and, in substance, provides some degree of added protection to other parties to the transaction."

In the context of securitisation of standard assets, as per RBI guidelines, credit enhancement is a cover to a special purpose vehicle in respect of any future losses associated with the pool of assets.

It will appear from the points of distinction between synthetic and traditional securitisation as mentioned earlier, that although in case of former the underlying assets remain in the books of the originator Bank, the credit derivative provides the benefit of credit enhancement. Even in circumstances when assets are sold and transferred from the books of the transferor Bank to special purposes vehicle and guarantee is provided by them to SPV, the same will be credit enhanced.

Example of Operation of Securitisation Transaction (Traditional)

Stage One:

Model Bank Ltd. sanctions loans to various Home Loan buyers against mortgage of land and building.

Stage Two:

Bank decides to sell / transfer its entire Home Loan outstanding balances of Rs. 100 crore. All such accounts stand classified as performing (standard) assets.

Stage Three:

A special purpose vehicle (SPV) / Special Purpose Entity (SPE) is created by the Bank and Home Loan accounts aggregating Rs. 100 crore are transferred by way of sale to SPV/SPE (SPV/SPE is a partnership firm, Company, Trust or other entity organised for a specific purpose. While Basel Accord uses the term SPE, RBI uses it as SPV. There is no other difference).

Stage Four:

Model Bank provides guarantee to SPV/SPE and in turn, investors (for the securities) would have added comfort of payments.

Stage Five:

SPV / SPE issues transferable and tradable securities with/without credit enhancement by Model Bank to the investors who have to make cash payments for purchase of securities covered by underlying assets.

Stage Six:

Cash received by SPV/SPE is passed on to Model Bank after deduction of its fees/charges.

Final Stage:

As and when repayments are made by the concerned Home Loan borrowers to Model Bank (they are not concerned whether Loan accounts are sold or not, and they are to repay only to Model Bank), the same are passed on to SPV / SPE for eventual remittance to the investors of securities.

Basel Accord II Guidelines On Operational Requirements Of Securitisation

Basel Accord II has laid down separate operational requirement for (I) Traditional Securitisation and (II) Synthetic Securitisation, the major points of which are presented below:

I. For Traditional Securitisation:

- Transferor-Bank must not maintain effective or indirect control over the transferred exposures.
- Assets packaged for securitisation purposes must be legally isolated from the Transferor-Bank by way of sale of assets/ sub participation, etc.
- Opinion from a qualified legal counsel must be obtained before effecting transfer.
- Investor purchasing the securities (of the securitised exposures) would have claim only to the underlying pool of exposures– no financial obligation from the Transferor–Bank (unless credit enhancement is made available through SPV / SPE).
- The transferee must be a legally constituted SPV/SPE through a duly stamped/registered deed.
- The Transferor-Bank has to satisfy the requirement that significant credit risk of the exposure stands transferred to third parties (e.g. covered by deed of guarantee).

Note:

If the aforesaid conditions are complied with, the originator (i.e. Transferor-Bank) will not be required to hold any 'capital' for transferred assets (sold assets).

II. For Synthetic Securitisation:

- Guarantees from sovereign entities, public sector entities, banks are only acceptable without any credit rating requirement.
- For guarantees from other entities they must at least be 'A' rated.
- SPV/SPE is not recognised as Guarantor.

- As in the case of traditional securitisation mentioned above it must be satisfied that significant credit risk is transferred to third parties. Also opinion from a qualified legal counsel must be obtained for effecting any synthetic securitisation.

Applicability Of Risk Weights

A Bank undertaking securitisation of exposures otherwise than on 'true sale' basis is required to compute risk-weighted amount of securitisation exposures by multiplying the amount of the position by risk weights summarised as under as per Basel Accord II:

A. Long Term Rating Category:

- When External Credit Assessment is 'AAA to AA-': 20%
- When External Credit Assessment is 'A+ to A-': 50%
- When External Credit Assessment is 'BBB+' to 'BB-': 100%

B. Short Term Rating Category:

- When External Credit Assessment is A-1/P-1 : 20%
- When External Credit Assessment is A-2/P-2 : 50%
- When External Credit Assessment is A-3/P-3 : 100%

Disclosure Requirements:

Basel Accord II provides that for securitisation exposures of Banks the necessary disclosures—both qualitative and quantitative—must periodically be made by Banks/Credit Institutions to the public. The disclosure guidelines are summarised below:

- Qualitative Disclosures: (I) Bank's/Credit Institution's objectives in relation to securitisation activity must be appropriately documented and such documented objectives be disclosed. (II) Summary of Bank's/Credit Institution's policies for securitisation activities–whether transactions are recorded as SALES OR FINANCING.
- Quantitative Disclosures: (I) Total outstanding exposures securitised by the Bank / Credit Institution duly bifurcated into traditional and synthetic securitisation. (II) Amount of Non-performing loan & Advances securitised and losses recognised by the Bank (as per RBI's recent directive Indian Banks/Credit Institutions are presently permitted to securitise only Standard Assets – NPAs are excluded). (III) Aggregate amount of securitisation exposures retained, etc.

Indian Financial System: Scope for Successful Operation of Securitisation Method:

Securitisation transactions are yet to take off in Indian Financial System in a significant way. With more than 100 commercial Banks and their large network of branches occupying large share, the scope of application of sophisticated system of credit risk management – in particular with securitisation method, is limited. True securitisation initiative is required to be managed at corporate headquarters of Banks and to that extent Bank branches have hardly any role to play. But since loans and advances under a particular category, say Home Loans, of all branches of the Banks/Credit Institutions, are to be pooled/packaged, the respective branches would have to be involved at various stages during the subsistence of particular borrowal accounts taken under the pool.

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Even though above operational aspect may pose initial constraints, it may be stated that securitisation of credit exposures – (especially

performing borrowal accounts) may serve the following main purposes:

- Initial Lending Bank (Originator) may be benefited by way of reduction of exposure in case of traditional securitisation when it considers it so necessary and the proceeds may be utilized towards other avenues of deployment.
- Since the Lending Bank must have undertaken 'due diligence' before disbursement of particular category of loans/advances, the eventual investors would have reasonable comforts of repayment as per agreed terms from the underlying assets.
- Assuming that a particular Bank/Credit Institution considers its loans/advances portfolio safe and secure and within the prudential exposure norms, in times of liquidity crunch (as is recently being noticed in Indian banking system) it may be worthwhile to unload "fixed interest rate" loans when prevailing market rates are higher while Bank has large portfolio of floating interest liability.
- Synthetic securitisation (credit derivative) helps initial Lending Bank when subsequently it considers it necessary to have external protection/cover for a particular portfolio (for example, say, Diamond Industry shows signs of decline and for the Bank holding large portfolio of diamond loans it may need a credit derivative) while another Bank based on its risk philosophy and risk appetite may welcome fresh exposure to that particular category. In that scenario, credit derivative (Guarantee) by the investing Bank may enable it to earn revenue from that category without booking the advance in its books. On the other hand, the initial Lending Bank would have necessary protection/comforts for the exposure.
- In essence, liquidity crunch and/or need for protection/cover by the initial Lending Bank triggers off the utilisation of securitisation window in the Indian context, major hurdle is stamp duty on legal documentation of securitisation exposures. Since various states have different scales of stamp duty it is necessary that there should be a uniform stamp duty structure all over India in respect of securitisation exposures.

Recent press reports indicate that some leading commercial banks like SBI intend to avail of securitisation opportunities as a measure of tackling increasing liquidity problems.

Incidentally, with regard to the applicability of prudential norms for investment in the securities issued by a special purpose vehicle (SPV) arising out of securitisation exposures by another Bank, RBI has clarified that such investments would be in the nature of NON SLR (Statutory Liquidity Ratio) securities subject to prudential norms.

Conclusion

Conceptually, securitisation of credit exposures covers performing assets as well as non-performing assets of Banks/Credit Institutions. It is the order of the day in global finance management that wherever opportunities exist and legal and economic structures are conducive, banks/credit institutions do securitise a part of the loan assets, not only from the angle of dealing with liquidity issues but also often as a cover of risks associated with a pool of exposures by way of synthetic securitisation.

Indian financial environment is yet to match that of USA (where securitisation is a regular affair) and other advanced countries. Successful application of securitisation technique demands technology-driven banking system. It may take up to a decade before technology level is raised to the international level in India. Another pertinent aspect is of legal infrastructure. Till uniformity in stamp duty across all states in India is initiated for securitisation exposures, such transactions may be restricted to states with lower stamp duty, and hence growth of securitisation market may not be significant.

Bank officers/staff members who will deal with securitisation exposures will be required to develop new skill set by exposing themselves to short duration on-the-job training in advanced countries and/or at reputed training establishments in India. ❐