

“Securitisation”

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* *What is Securitisation?*

- ❑ A financial transaction in which assets are pooled and securities representing interests in the pool are issued.

- ❑ Assets primarily securitised include:
 - a. Auto Loans

 - b. Student Loans

 - c. Mortgages

 - d. Credit Card Receivables

 - e. Lease Payments

 - f. Accounts Receivables

 - g. corporate or sovereign debt, etc.

* Case Study

A financing company X has issued a large number of auto loans and wants to raise cash so it can issue more loans.

Possible Solutions and Outcomes:

- ✓ To sell off its existing loans :
There may not be a liquid secondary market for individual auto loans
- ✓ The firm pools a large number of its loans and sells interests in the pool to investors :
The financing company X and the investors stand benefitted

Company X

Raise capital and get the loans off its balance sheet

Issue new loans

Investors

Create a liquid investment in a diversified pool of auto loans, which may be an attractive alternative to a corporate bond or other fixed income investment.

* *Different parties involved in Securitisation*

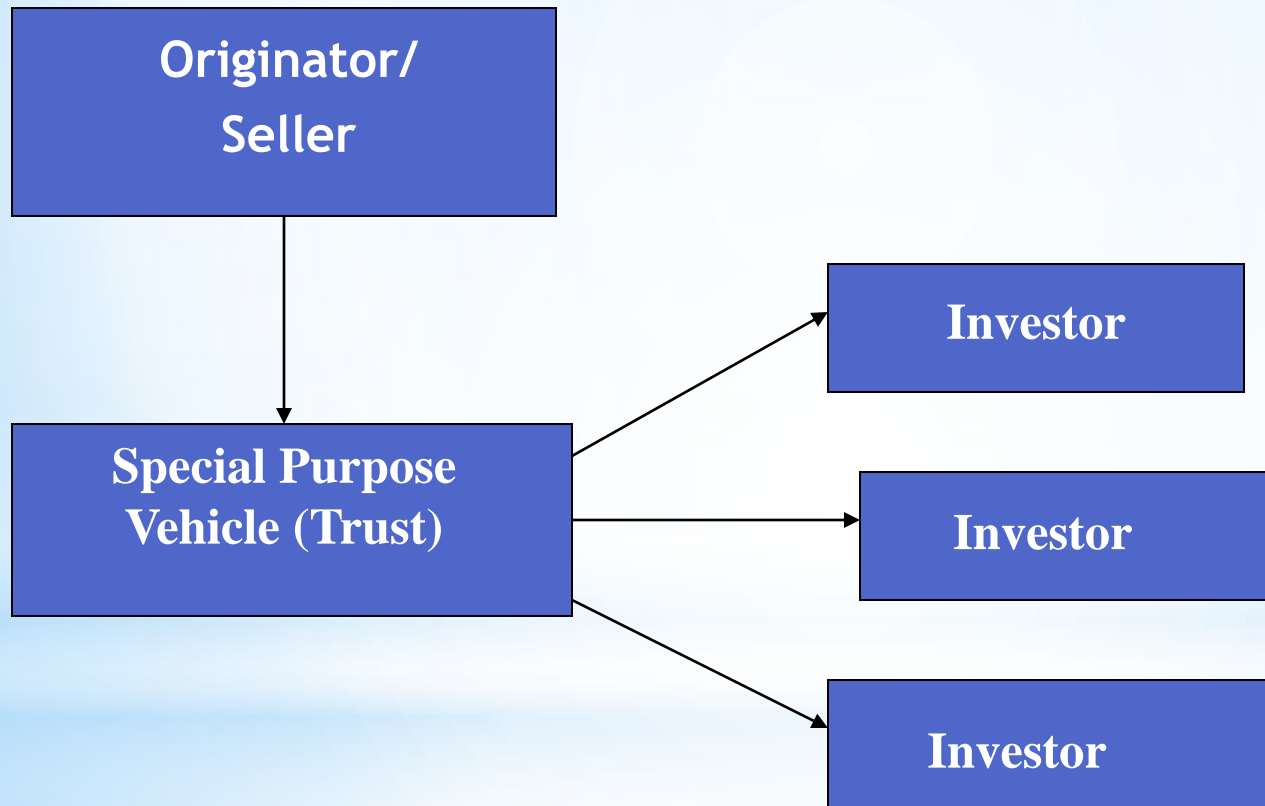
- ❑ **Originator / Seller** : 'Originator' refers to a bank that transfers from its balance sheet a single asset or a pool of assets to an SPV as a part of a securitization transaction and would include other entities of the consolidated group to which the bank belongs.
- ❑ **Obligors**: The debtors who must pay the originator. They are not active parties to the transaction but their obligations to pay to the originator are transferred to the SPV.
- ❑ **Special Purpose Vehicle/ Issuer** : 'SPV' means any company, trust, or other entity constituted or established for a specific purpose - (a) activities of which are limited to those for accomplishing the purpose of the company, trust or other entity as the case may be; and (b) which is structured in a manner intended to isolate the corporation, trust or entity as the case may be, from the credit risk of an originator to make it bankruptcy remote. 'Bankruptcy remote' means the unlikelihood of an entity being subjected to voluntary or involuntary bankruptcy proceedings, including by the originator or its creditors.

* *Different parties involved in Securitisation*

contd...

- **Indenture Trustee holding security interest**: The trustee holding ownership or security interest on the assets of the issue for the benefit of the investors and also maintaining a general surveillance on the transaction.
- **Investors** : Investors in PTCs are mostly insurance companies, mutual funds and private banks. Although several prepayment-protected transaction structures have emerged in the market recently, offering a fixed income and fixed maturity notes and making it easier for mutual funds to invest into PTCs, the investor community remains limited.
- **Servicing Agent** : The party that will take over the servicing, that is, the entire interface required with the obligors and investors including collections and remittances.

Pictorial Presentation of various parties



* *Important Terms*

- **Credit Enhancement** : Any methodology that reduces the risk due to uncertainty in a counterparty's ability to meet its obligations.

Techniques of credit enhancement include:

1. **Collateralization**: One or more parties may agree to post collateral. Collateral levels may be fixed or vary over time to reflect the market value of different parties' obligations.
2. **Third party loan guarantees**: A parent company or other third party may be contractually bound to meet the obligations of one party should that party default.
3. **Credit insurance**: An insurance policy may provide for compensation in the event that a party defaults.
4. **Letters of credit**: A bank may confirm financing.

* *Important Terms contd.....*

- ❑ **Bankruptcy Remote**: A key concern in securitization transactions to ensure that the transfer of assets of the originator to the investors' representative or SPV is not affected by bankruptcy or distress of the originator.
- ❑ **Discount Rate** : Relative to securitizations, refers the interest rate used for computing the purchase price of receivables or the rate for computing present value of a sum payable in future.
- ❑ **Excess spread** : Refers to the excess of the income inherent in the portfolio of receivables, over and above the SPV's discounting rate and the expenses of the transaction. Represents the profit of the originator in the securitization transaction
- ❑ **Loan to value ratio** : In case of asset-based lending, means the amount of loan as a percent of the value of the asset on which the loan is secured.

* *Important Terms contd.....*

- **Prepayment** : Is an payment by a borrower in advance of the scheduled payment date. Prepayment Risk is the potential loss due to prepayment by an obligor. The SPV may either pass through the prepaid amounts to investors thus resulting into faster payment of principal than expected, and reduced income over time, or if the SPV were to reinvest this money, the reinvestment may not produce rate of return as in the underlying receivables. Hence, prepayment is viewed as a risk in securitization. It implies loss of profit but not loss of profitability. The same amount can be reinvested but unfortunately the interest rates may have fallen.
- **Seasoned** :It describes the aging process underlying collateral. It refers to mortgages, which are at least 30 months old and are expected to have relatively stable prepayment rates.
- **Vintage** : Time when the advances originated.

* *Important Documents in a typical Securitisation transaction*

- **Deed of Assignment** : Under a normal securitization, a pool of assets is assigned to the SPV by way of an assignment agreement. The SPV, subsequent to such an agreement, becomes the sole owner of the receivables and holds the interest in the assets on behalf of the noteholders. This separates the assets completely from the originator (seller). The deed of assignment constitutes a document indicating assignment of assets. Can be challenged in Court
- **Trust deed** : The Trust Deed will, inter alia, set out the purposes of the Trust and include obligations on the trustees to establish and maintain the SPV.
- **Information Memorandum** : Cannot be challenged in Court

* *Actual Legal Methodology*

- ❑ The actual legal methodology involved in transferring the receivables is mostly a complicated legal question. Indian jurisdiction distinguishes between legal and equitable assignments.
- ❑ A Legal assignment is a full-scale assignment which requires notices to debtors which is mostly impracticable as the originator would like to maintain continuing relations with the debtor and would not even like the debtors to come to know of the fact of securitization.
- ❑ An equitable assignment, though recognized in law, creates only equitable interest in the receivables in favor of SPV. Any suit for recovery of debts would have to be filed by the originator.
- ❑ In absence of clear laws in India regarding transfers, the choice has to be made between a cumbersome & costly legal procedure and a practical method that involves some legal risk.

Thank You