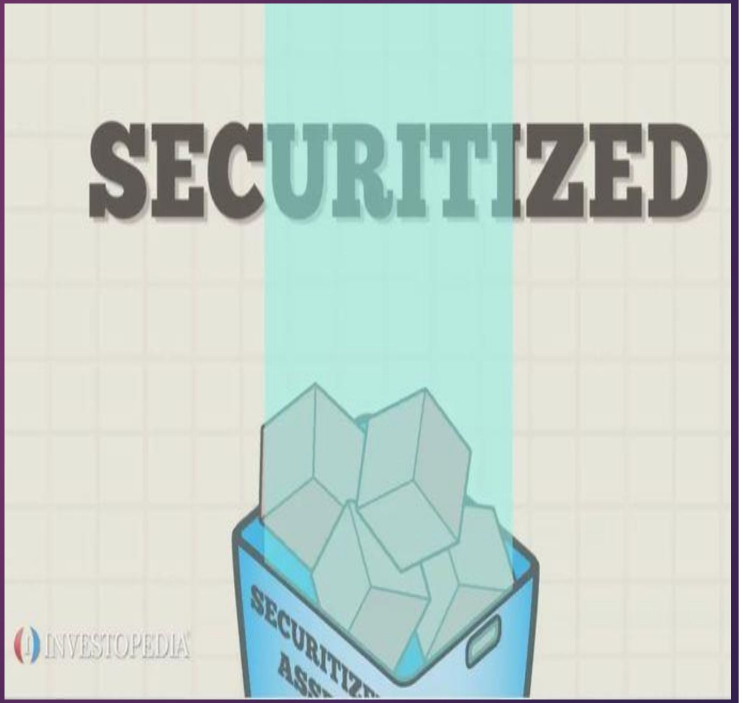
SECURITISATION OF DEBTS



Meaning:

Securitization is the process of taking an illiquid asset, or group of assets, and through financial engineering, transforming them into a security.

Definition:

"Securitization is a process by which a company clubs its different financial assets/debts to form a consolidated financial instrument which is issued to investors. In return, the investors in such securities get interest."

The Economic Times.

Asset Classes:

Typically, any asset that produces a predictable stream of cash flows can be securitised. The types of assets that are securitised today include:

- Mortgage-backed
  - Residential mortgage-backed securities (RMBS)
  - Commercial mortgage-backed securities (CMBS)

Parties involved in Securitisation:

- The Originator: This is the entity on whose books the assets to be securitised exist and is the prime mover of the deal.
- The SPV: This entity is the issuer of the bond/security paper and is typically a low-capitalised entity with narrowly defined purposes and activities.

- <u>The Investors</u>: The investors buy a participating interest in the total pool of assets and receive their payments in the form of interest and principal as per an agreed pattern.
- <u>The Obligor(s)</u>: The obligor is the Originator's debtor or the borrower of the original loan.

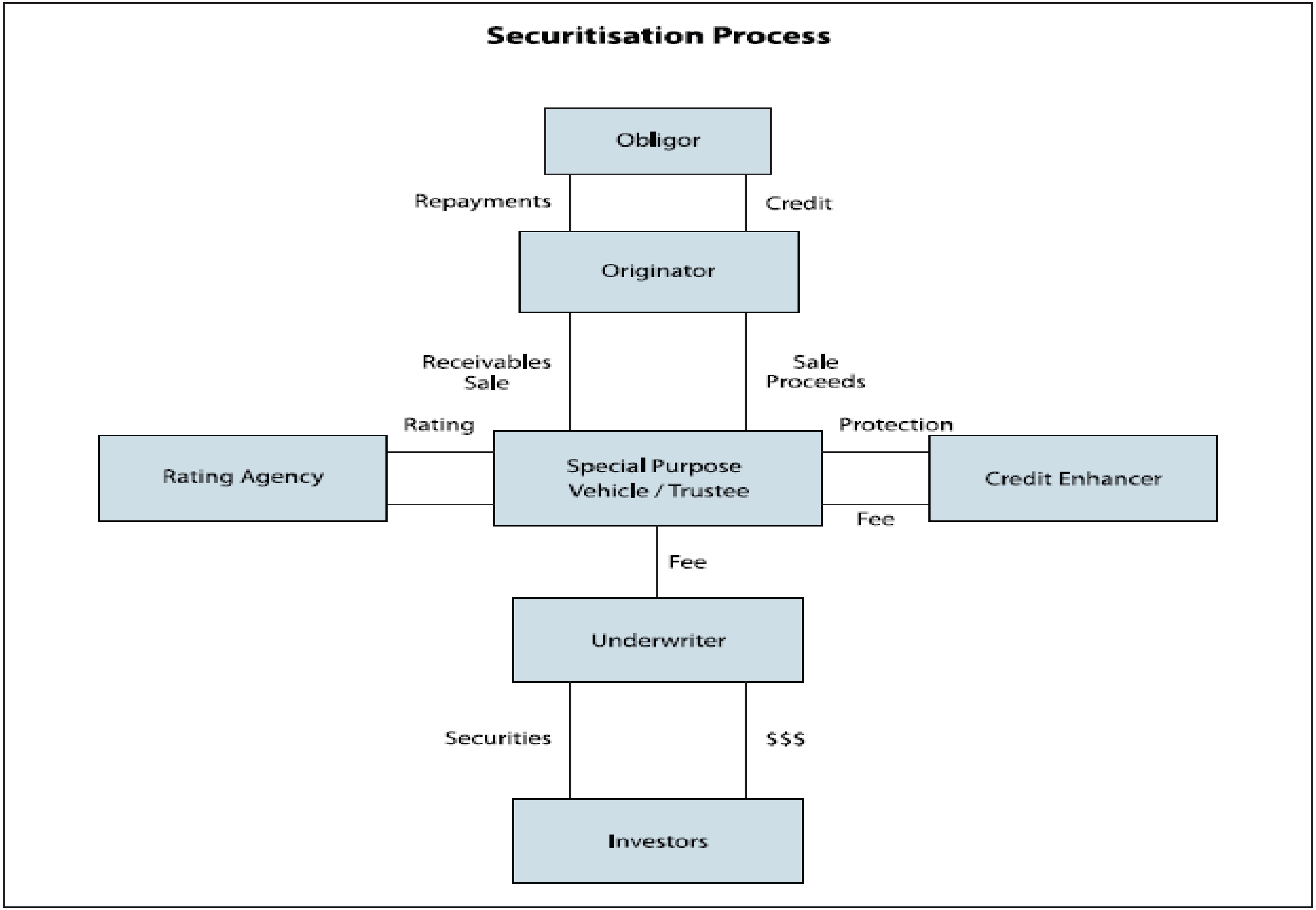
- The Rating Agency: The rating process assesses the strength of the cash flows and the mechanism designed to ensure full and timely payment.
- Administrator or Servicer: Also called as the receiving and paying agent, it collects the payment due from the Obligor(s) and passes it to the SPV.

- Agent and Trustee: Its principal role is to look after the interests of the investors.
- External Credit Enhancements: Underwriters sometime resort to external credit enhancements to improve the credit profile of the instruments.

Stages involved in the process of securitisation:

- Identification process
- Transfer process
- Issue process
- Redemption process
- Credit rating process

Process of securitisation:



<u>SECURITISATION INSTRUMENTS</u>

- **<u>Pass through certificates</u>**: A **pass-through certificates** (PTC) is an instrument that evidences the ownership of two or more equipment trust **certificates.** Generally home loans etc single maturity
- **<u>Pay through securities</u>**: These securities are fully amortizing bonds resembling modified pass-through securities, paying interest at scheduled intervals, monthly or quarterly. Multiple maturity

- **Stripped securities**: The securities sold are classified as "Interest only" or "Principal only" securities. Interest only securities are paid back out of interest income only and Principal only security holders are paid out of principal repayments only.

Benefits of securitisation to the issuer:

- Arbitrage
- Capital adequacy requirement
- Undistributed credit lines
- Off balance sheet transaction

Benefits to the investors:

- Better security
- Rating
- Default

Disadvantages to the issuer and investor:

- More complicated
- May not always lead to off-balance-sheet treatment.
- Certain securitizations carry prepayment risk - the chance that the deal's cash flows accelerate from expectations.
- Risk of no payment of regular interest and principal, E.g. Subprime crisis, 2008.

Securitisation in India

- Debt securitisation in indian market began to take off when the first securitisation deal was structured by CITI bank in 1991.
- HDFC was the first Indian bank to initiate the experiment i.e. selling a part of its loan to ILFS.
- Later on ICICI and other private financial companies started dealing for lease rentals.
- Asset securitisation have entered the indian markets but have not spread into large scale.

Reasons for unpopularity of securitisation:

- Lack of debt instruments market
- Financial institution's support is lacking
- Absence of agencies such as SPV
- Difficulty in transfer of assets
- Higher stamp and transfer charges
- True sale
- Taxation and accounting
- Eligibility