

INTRODUCTION

Some companies who are **involved in making credit sale** have a huge balance of receivables in their Balance Sheet and still they may **face liquidity crunch** to run business. One way may to adopt **borrowing route**, but this results in **changing debt equity ratio** of company which may not only be acceptable to some stakeholders but also **put companies to financial risk**. To overcome this problem the term '**securitization**' was coined.

The process of securitization typically involves the

- **creation of pool of assets**
- from the **illiquid financial assets**, such as **receivables or loans** which are marketable.

In other words, it is the **process of repackaging or rebundling of illiquid assets into marketable securities**. These assets can be **automobile loans, credit card receivables, residential mortgages etc.**

FEATURES OF SECURITISATION

- 1) **Creation of Financial Instruments** - process of **creation of additional financial product of securities in market backed by collaterals**.
- 2) **Bundling and Unbundling** - When all assets are **combined in one pool it is bundling** and when these are **broken into instruments of fixed denomination it is unbundling**.
- 3) **Tool of Risk Management** - In **non-recourse basis**, securitization process **acts as risk management as the risk of default is shifted from originator to investor**.
- 4) **Structured Finance** - financial instruments are **tailor structured to meet the risk return trade of profile of investor**.
- 5) **Trenching** - Portfolio of different receivable or loan or asset are **split into several parts based on risk and return they carry called 'Tranche'**. Each Trench carries a different level of risk and return.
- 6) **Homogeneity** - Under each tranche the securities issued are of **homogenous nature** and even meant for small investors who can afford to invest in small amounts.

BENEFITS OF SECURITIZATION

From the angle of originator

- (i) **Off - Balance Sheet Financing**: it **releases a portion of capital tied up in these assets** resulting in off Balance Sheet financing leading to **improved liquidity position**.
- (ii) **More specialization in main business**: entity could **concentrate more on core business**. Further, in case of non-recourse even the **burden of default is shifted**.
- (iii) **Helps to improve financial ratios**: Especially in Financial Institutions and Banks, **it helps to manage Capital -To-Weighted Asset Ratio** effectively.
- (iv) **Reduced borrowing Cost**: Since **securitized papers are rated due to credit enhancement** and hence, they can be issued at reduced rate due to which the originator **earns a spread**, resulting in **reduced cost of borrowings**.

From the angle of investor

- (i) **Diversification of Risk**: Purchase of securities backed by different types of assets provides **diversification of portfolio** resulting in **reduction of risk**.

- (ii) **Regulatory requirement:** helps banks to meet regulatory requirement of investment of fund in industry specific.
- (iii) **Protection against default:** In recourse arrangement if there is any default, then originator shall make good the least amount. Moreover, there can be insurance arrangement for compensation for any such default.

PARTICIPANTS IN SECURITIZATION

Primary Participants

- a) **Originator (Initiator or Securitizer) :** entity which sells assets lying in its books to SPV and receives funds generated through the sale of such assets.
- b) **Special Purpose Vehicle:** Main objective of creating SPV is to remove the asset from Balance Sheet of Originator. Since, SPV makes upfront payment to originator, it holds key position in the overall process of securitization. it also issues securities to the investors.
- c) **The Investors:** Investors are buyers of securitized papers (may be an individual, an institutional investor such as mutual funds, provident funds, insurance companies, Financial Institutions etc). They receive their money back in the form of interest and principal as per terms agreed.

Secondary Participants

- a) **Obligors:** They are the parties who owe money to the firm and are assets in the Balance Sheet of Originator. The amount due from the obligor is transferred to SPV and their credit standing is of paramount importance in the whole process.
- b) **Rating Agency:** the assets have to be assessed in terms of its credit quality and credit support available. Rating agency assesses the following

Strength of the Cash Flow	Credit quality of securities	Strength of legal framework
Mechanism to ensure timely interest and principle repayment		Liquidity support

- c) **Receiving and Paying Agent (RPA):** it collects payment due from obligors and passes it to SPV. It also follow up with defaulting borrower and if required. initiate appropriate legal action.
- d) **Agent or Trustee:** Trustees are appointed to oversee that all parties to the deal perform in the true spirit of terms of agreement. it takes care of interest of investors who acquires securities.
- e) **Credit Enhancer:** Since investors directly exposed to performance of the underlying and sometime may have limited or no recourse to the originator, they seek additional comfort in the form of credit enhancement. Originator itself or a third party say a bank may provide this additional context called Credit Enhancer. While originator provides his comfort in the form of over collateralization or cash collateral, the third party provides it in form of letter of credit or surety bonds.
- f) **Structurer:** It brings together the originator, investors, credit enhancers and other parties to the deal of securitization. Normally, these are investment bankers also called arranger of the deal.

MECHANISM OF SECURITIZATION (steps in securitization mechanism)

- 1) **Creation of Pool of Assets -** The process of securitization begins with creation of pool of assets by segregation of assets backed by similar type of mortgages in terms of interest rate, risk, maturity and concentration units.

- 2) **Transfer to SPV** - One assets have been pooled, they are transferred to Special Purpose Vehicle (SPV) especially created for this purpose.
- 3) **Sale of Securitized Papers** - SPV designs the instruments based on nature of interest, risk, tenure etc. based on pool of assets. These instruments can be Pass Through Security or Pay Through Certificates.
- 4) **Administration of assets** - The administration of assets is subcontracted back to originator which collects principal and interest from underlying assets and transfer it to SPV.
- 5) **Recourse to Originator** - Performance of securitized papers depends on the performance of underlying assets and unless specified in case of default they go back to originator from SPV.
- 6) **Repayment of funds** - SPV will repay the funds in form of interest and principal to the investor that arises from the assets pooled.
- 7) **Credit Rating to Instruments** - Sometime before the sale of securitized instruments credit rating can be done to assess the risk of the issuer.

PROBLEMS IN SECURITIZATION

- a) **Stamp Duty** - Stamp Duty is one of the obstacle in India. A mortgage debt stamp duty which even goes upto 12% in some states of India and this impeded the growth of securitization in India.
- b) **Taxation** - In the absence of any specific provision relating to securitized instruments in Income Tax Act Some experts are of opinion that SPV is liable to be taxed then others are of view that instead of SPV, investors will be taxed on their share of income.
- c) **Accounting** - Although securitization is slated to be an off-balance sheet instrument but in true sense receivables are removed from originator's balance sheet. Problem arises especially when assets are transferred without recourse.
- d) **Lack of standardization** - Every originator following his own format for documentation and administration having lack of standardization is another obstacle in the growth of securitization.
- e) **Inadequate Debt Market** - Lack of existence of a well-developed debt market in India is another obstacle that hinders the growth of secondary market of securitized or asset backed securities.
- f) **Ineffective Foreclosure laws** - foreclosure laws are not supportive to lending institutions as lenders face difficulty in transfer of property in event of default by the borrower. (esp. in mortgaged backed securities)

SECURITIZATION INSTRUMENTS

On the basis of different maturity characteristics, the securitized instruments can be divided into following three categories:

- a) **Pass Through Certificates (PTCs)**
Here originator transfers the entire receipt of cash (Interest, Principal, Prepayment) to investors on proportionate basis. since it is a direct route any prepayment of principal is also proportionately distributed among the securities holders i.e. investors

b) Pay Through Security (PTS)

SPV debt securities are backed by the assets and hence it can **restructure different tranches from varying maturities of receivables**. this structure also **permits the SPV to reinvest surplus funds for short term**.

Since, in Pass Through, all cash flow passes immediately to investors but, in PTS in case of **early retirement of receivables** the **suplus cash** can be **used for short term yield**.

c) Stripped Securities

Stripped Securities created by dividing cash flows associated with underlying securities into two or more new securities. i) **Interest Only (IO) Securities** ii) **Principle Only (PO) Securities** Accordingly, the **holder of IO securities receives only interest** while **PO security holder receives only principal**.

i) In case **yield to maturity** in market **rises**, **IO price increases** but **PO price tends to fall**.

ii) In case **yield to maturity** in market **falls**, **IO price decrease** but **PO price tends to rise**.

PRICING OF THE SECURITIZED INSTRUMENTS

it is important that it should be acceptable to both **originators** as well as to the **investors**.

Pricing of securities can be divided into following two categories:

<u>From originator's angle</u> , the instruments can be priced at a rate at which originator has to incur an outflow and if that outflow can be amortized over a period of time by investing the amount raised through securitization.	<u>From an investor's angle</u> security price can be determined by discounting best estimate of expected future cash flows using rate of yield to maturity of comparable security with respect to credit quality and average life of the securities .
--	---

SECURITIZATION IN INDIA

It is the **Citi Bank** who **pioneered the concept of securitization in India by bundling of auto loans into securitized instruments**. Thereafter many organizations securitized their receivables.

In order **to encourage securitization**, the Government has come out with **Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002**, to **tackle menace of Non-Performing Assets (NPAs) without approaching the Court**.

As mentioned above, though, initially started with auto loan receivables, it has become an important source of funding for micro finance companies and NBFCs and even now a days commercial mortgage-backed securities are also emerging.

RISKS IN SECURITIZATION

- (i) **Credit Risk or Counter Party Risk** - risk of bankruptcy and non performance of servicer
- (ii) **Legal Risks** - absence of conclusive judicial precedent or explicit statutory provision
- (iii) **Market Risks**
 - i) Macro Economic Risk
 - ii) Prepayment Risk
 - iii) Interest Rate Risk

TOKENIZATION AND BLOCKCHAIN

Blockchain, sometimes referred to as Distributed Ledger Technology (DLT) is a shared, peer-to-peer, and decentralized open ledger of transactions system with no trusted third parties in between. This ledger database has every entry as permanent as it is an append-only database which cannot be changed or altered. All transactions are fully irreversible with any change in the transaction being recorded as a new transaction. The decentralised network refers to the network which is not controlled by any bank, corporation, or government.

A block chain generally uses a chain of blocks, with each block representing the digital information stored in public database ("the chain"). Example is Google doc. Which is shared with group of people instead of copied or transferred.

Applications of Blockchain

1. Financial Services - provide automated trade lifecycle in terms of transaction log of any transaction of asset or property.
2. Healthcare - provide secure sharing of data in healthcare industry increasing privacy and security
3. Government - Decentralization is necessary esp. in land and vehicle registration, e-voting etc.
4. Travel Industry - Applied in money transaction and storing important documents like passport etc.
5. Economic Forecasts - financial and economic forecast based on decentralised prediction markets, decentralised voting and stock trading.

Meaning of Tokenization

It is a process of converting tangible and intangible assets into blockchain tokens. Digitally representing anything has recently acquired a lot of traction. It can be effective in conventional industries like real estate, artwork etc.

Tokenization and Securitization

Since tokenization of illiquid assets attempts to convert illiquid assets into a product that is liquid and tradable and hence to some extent it resembles the process of Securitization. Hence, following are some similarities between Tokenization and Securitization:

- (i) Liquidity: - First and foremost both Securitization and Tokenization inject liquidity in the market for the assets which are otherwise illiquid assets.
- (ii) Diversification: - Both help investors to diversify their portfolio thus managing risk and optimizing returns.
- (iii) Trading: - Both are tradable hence helps to generate wealth.
- (iv) New Opportunities: - Both provide opportunities for financial institutions and related agencies to earn income through collection of fees.