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Conceptual Analysis of Securitization

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ABSTRACT

"Under investment, what is comfortable is seldom profitable. "

The process of securitization has become an efficient technique for the liquidation of assets by way of dividing risks into marketable securities. In recent years, this industry has gained importance in light of its advantage of allowing cash flow in the market which in turn results in easy lending to the borrowers, thus, making this industry an important pillar in the banking business. Securitization is a concept of finance that has an impact on the economy, just like any other industry of finance, this industry is also regulated by the central government and other important bodies. These regulations become important to promote securitization during adverse events and in recent years, there have been several ups and downs in this industry, one of the major being, the coronavirus which made the industry struggle to adapt to the adversity of the economy. Considering the importance of this sector, the students wish to undertake a conceptual analysis of securitization in the Indian market by way critically analysing the recent development in the given industry. This analysis aims to present a holistic picture of the process of securitization and also unfolds certain obstacles in the same, lastly, the students have concluded by presenting certain policy recommendations for this ever-lasting industry to grow and adapt to the changing environment in the securities market.

Keywords: *The central government, economy, laws, market, and securitization.*

I. INTRODUCTION

At the most basic level, the word securities have been derived from an old French word "*securite*[3]" which means to be free from care, presently in the capital market it refers to an instrument that has monetary value and can be traded for liquidity. To have a flourishing market, the role of furnishing securities by process of securitization becomes important since the assets are turned into securities for further trading in the market to enable the cash flow in the economy.

Further, this market serves as a backbone of banking business by securing the assets of the bank which in turn results in the smooth lending process of the banking industry. Additionally, it is

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[3] OXFORD LANGUAGES, https://languages.oup.com/google-dictionary-en/, (last visited on August 29th, 2023).

to be noted that by way of securitization, the interest and the payment gained from the assets can be directly passed to the purchasers of securities, resulting in a win-win situation for the investors as well.[4]

This market is regulated by the central government, Reserve Bank of India, and the Securities and Exchange Board of India by passing various rules and notifications for fostering this industry. In light of the same, the ***Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002*** (hereinafter referred to as ***SARFAESI***) was passed by the government to better regulate the industry and to outgrow the forthcoming challenges.

Securitization has been defined under section 2 (z) of the SARFAESI[5] as

"***A process of acquisition of financial assets by an asset reconstruction company from any person being the owner of the financial asset via issuing security receipts representing an undivided interest in given acquired assets***."

(A) Objectives of the study along with statement of purpose

The students aim to unfold several aspects of securitization and its impact on the Indian economy via this research article. While doing so, the major focus of the study lies in understanding how this industry works and analysing the SARFEASI Act in this regard.[6]

Via this study, the students aims to achieve the following objectives:

- To analyse the securitization market and its impact on lending activities.
- To understand the process of securitization and the involvement of several bodies and financial institutions.
- To unfold certain challenges of the securitization industry.
- To present certain recommendations for overcoming the challenges

II. Overview of Securitization Framework in India

At the most basic level, securitization refers to the process of conversion of illiquid assets into liquid assets by selling them to an intermediary who in turn breaks the same into marketable securities. The process of the same is as follows:

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[4] Andreas Jobst, *What is Securitization?*, INTERNATIONAL MONETARY FUND, (Aug. 29, 2023, 1:07 PM), https://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf.

[5] Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, § 2, No. 54, Acts of Parliament, 2002 (India).

[6] INSTITUTE OF COMPANY SECRETARIES OF INDIA, https://www.icsi.edu/media/webmodules/publications/CapitalMarketandSecuritesLaw.pdf, (last visited on August 29th, 2023).

- There is a borrower in need of a loan and such a person approaches the bank for loan for mortgaging the property to acquire the loan from the bank and the bank grants the loan. The bank, here, does not purchase the entire mortgage property, but only takes the title deed of the same.
- This process continues, and more borrowers approach the bank for loans who are ready to mortgage the property by depositing the title deed with the bank in return for a secured loan.
- These title deeds and other property documents are commonly referred to as a mortgage pool on whose backing the banking company has distributed its liquid funds to the borrower in the form of loans as a result, banks remain only with fixed assets of title deeds which are illiquid.
- In the future, to give loans to more borrowers, the bank appoints a special purpose vehicle that acts as an agent on behalf of the bank and will take over or purchase the mortgage pool in return for providing liquid assets of cash to the bank for running its lending activities, thus, these SPVs protects the bank from insolvency and bankruptcy.
- These SPVs also undertake another task of analysing the mortgage pool in the sense of when the loan along with the interest will give the return on investment, for this purpose, SPVs appoint the credit rating agencies to rate the mortgage pool and here SPVs also start issuing the securities as bonds which is known as securitization.
- Whosoever buys these bonds get an assurance from the SPVs regarding the safe investment because there is an underlying backing of the mortgage pool, these bonds are called as mortgage-backed securities.
- Meanwhile, CRA also creates tranches or categories of this bond such as:
    - AAA- Low, most secured bond with no risk and belongs to the senior class of rating
    - AA- Moderate and belongs to the mezzanine class of rating.
    - A- High and belongs to the subordinate class of rating with high-risk
- Here, the investors have flexible investment opportunities with different tenure and maturity rates of bonds and offer cash to SPVs by way of subscription to these bonds, with all this cash flow, SPVs pay the cash amount to the bank for further giving loans to the borrowers.

- The major benefit here is all the parties get the chance to put up a margin of interest rates. In this whole process, we see that investors are the general public whole money is again shifted to borrowers who again are the general public.

III. Provisions of SARFEASI Act

Securitization has emerged as one of the most significant trends in international and national finance during the past few decades, and it is anticipated that it will continue to play an increasingly important role in the years to come. The practice of pooling and repackaging similar illiquid financial assets into marketable securities that can be offered to investors is known as securitization. The procedure results in the production of financial instruments that either reflect an ownership stake in a distinct income-generating asset or pool of assets or are secured by the presence of such an asset pool. Collateral for the securities is provided by the pool of assets.[7]

This process is regulated by the SARFAESI[8] and has the following objectives:

- To maintain a central database pertaining to security interests on property rights.
- To consolidate the laws relating to securitization and reconstruction of financial assets of banks and financial institutions.
- To safeguard the interest of all the stakeholders involved in the process for a smooth flow of cash in the economy.
- To empower the financial sector to achieve success in rapidly developing its economy.

When we lay emphasis on SARFAESI, it is to be noted that the same contains a total of VI chapters and 42 sections, however, for this research paper, the students aim to mention the provisions pertaining to the regulation of securitization and reconstruction of financial assets of banks and financial institution as mentioned in Chapter II of the same, ***these are as follows***:

1. **Section 3-**Every Asset Reconstruction Company (ARC) has to register with the Reserve Bank of India (RBI) to carry out such a business.
2. **Section 4-**RBI has the power to cancel the certificate of reservation if the ARC fails to follow any regulations related to SARFAESI. An appeal against the same lies to central government.
3. **Section 5-**ARC can acquire financial assets by issuing debenture/bond/entering into an

[7] SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1998971, (last visited on August 29th, 2023).
[8] Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, No. 54, Acts of Parliament, 2002 (India).

agreement, etc.

4. **Section 6-**The bank or financial institution have the right to give notice to the owner of the assets of acquisition.
5. **Section 7-**Upon acquisition, the ARC can issue security to other investors by raising receipts to qualified institute buyers or by creating schemes or raising funds.
6. **Section 9 – 10-**ARCs have the power to initiate proper management, sale/lease, settlement of dues, enforcement of interest, etc for asset reconstruction along with undertaking several other functions.
7. **Section 11-**If any dispute arises, then the parties should first seek arbitration or conciliation. Further, RBI has powers to determine directions for regulating ARC and can call for statement and information along with carrying out audit and inspection.

IV. Recent development in SARFAESI

The concept of securitization has been growing. However, *due to Covid 19, there was a decrease in the market due to high inflation rates* and the resentment of the investors to invest due to market instability. Despite the same, the importance of securitization to emerge as a major sector in the economy cannot be ignored.

SARFAESI and securitization have always been in the news and recently the *Securities and Exchange Board of India* (hereinafter referred to as SEBI)., *introduced legal identifiers system for issuers that are listed with Non-convertible Securities, securitized debt instruments, and security receipts*, in this regard it is imperative to note that this legal identifier has a peculiar 20 code character for analysing the entities involved in financial transactions, this was done to promote transparency in the process of SARFAESI.[9]

Moreover, it is to be noted that *according to the research, retail loan securitizations increased by 56% to Rs 1.76 lakh crore in the just-completed fiscal 2023*, while wholesale securitizations increased to roughly Rs 6,600 crore, finally emerging from the pandemic blues. The stable retail asset pools in the secondary market, as well as the propensity of banks to develop their retail assets to fulfil priority sector lending criteria, have contributed to a 56% increase in the secondary market for standard retail assets in FY23.[10]

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[9] Times of India, https://timesofindia.indiatimes.com/business/india-business/sebi-introduces-legal-identifier-system-for-issuers-with-listed-ncds-securitised-debt-security-receipts/articleshow/99965469.cms?from=mdr, (last visited on August 29th, 2023).

[10] Economic Times, https://economictimes.indiatimes.com/industry/banking/finance/banking/retail-loan-securitisation-rises-56-to-rs-1-76-lakh-cr-in-fy23/articleshow/99385624.cms?from=mdr, (last visited on August 29th, 2023).

V. Critical analysis

(A) Judicial precedents

- The Supreme Court (hereinafter referred to as SC) held in the case of *Kotak Mahindra Bank Ltd. v. Girnar Corrugators (P) Ltd.*,[11] that the SARFAESI Act recovery is given precedence over MSMED Act recovery. The MSMED Act's Section 24 makes clear, among other things, that the preceding sections from 15 to 23 take precedence. In contrast, Section 26-E of the SARFAESI Act states that the debts due to any secured creditor shall be paid in "*priority*" over all other debts.
- SC in the case of *Indiabulls Housing Finance Ltd. v. Deccan Chronicle Holdings Ltd.*,[12] held that the original financer is not covered under the ambit of SARFAESI and it is only applicable to all debts owing and live when the act itself becomes applicable.
- In the case of *SBI v. Allwyn Alloys (P) Ltd.*,[13] SC held that no other court or tribunal has the power to entertain the civil suit relating to SARFAESI and cannot grant an injunction in this regard, thus, only the Debt Recovery Tribunal and Debt Recovery Appellate Tribunal can examine the matter under SARFAESI.
- In the case of *State Bank of Patiala v. Mukesh Jain*,[14] it has been held by SC that the Debt Recovery Tribunal has no original jurisdiction to entertain the suits relating to debt less than 10 lakhs, however, it can exercise its appellate jurisdiction and entertain the same under SARFAESI.
- Without the intervention of the court, the SARFAESI framework enables the bank to seize the property for non-payment of dues in a timely manner. The SARFAESI Act's provision of a speedier remedy does not make that Act substantive or give rise to any new rights as been held in *M.D. Frozen Food Exports (P) Ltd. v. Hero Fincorp Ltd.*[15]
- In the case of *Pegasus Assets Reconstruction (P) Ltd. v. Haryana Concast Ltd.*,[16] it was held that the provisions of SARFAESI are completely distant from the Companies Act, 2013, Recovery of Debts due to Bank and Financial Institution Act, 1993, and State Financial Corporations Act, 1951, thus, the precedents in all these laws cannot be applied in SARFAESI due to different subject matter.

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[11] Kotak Mahindra Bank Ltd. v. Girnar Corrugators (P) Ltd., (2023) 3 SCC 210.
[12] Indiabulls Housing Finance Ltd. v. Deccan Chronicle Holdings Ltd., (2018) 14 SCC 783.
[13] SBI v. Allwyn Alloys (P) Ltd., (2018) 8 SCC 120.
[14] State Bank of Patiala v. Mukesh Jain, (2017) 1 SCC 53.
[15] M.D. Frozen Food Exports (P) Ltd. v. Hero Fincorp Ltd., (2017) 16 SCC 741.
[16] Pegasus Assets Reconstruction (P) Ltd. v. Haryana Concast Ltd., (2016) 2 SC 47.

- In the case of *Central Bank of India v. State of Kerala,*[17] it was held that the SARFAESI aims to ensure that all the dues of all the parties involved in the process are fully recovered from the defaulting borrowers.
- In yet another case of *Transcore v. Union of India,*[18] it has been held that section 6 of the SARFAESI is an enabling provision and banks have the discretion to give the notice, but the banks and financial institutions cannot be punished for not doing the same.

VI. Findings in the opinion of students in accordance with research objectives

The first objective was achieved by the students after analysing the concept of securitization in detail and the students holds the view that ***Mortgage-backed securities, the infrastructure sector, and other asset-backed are the three primary areas*** in which securitization is required in India. It has been observed that financial institutions and banks have achieved ***significant progress in funding projects in the real estate and infrastructure sector via securitization***. It is thus vital that securitization and other allied mechanisms get established for financial institutions and banks to be able to unload their initial risks and make room for funding future projects since it may help financial institutions and banks better manage their risk. As a result of the implementation of reforms to the financial sector at the beginning of the nineties, financial institutions and banks, in particular non-banking financial companies, have made significant inroads into the retail industry via this process. This has resulted in the production of large volumes of assets belonging to similar categories (for example, auto loans and credit cards). As a result of this, a few competitors have begun exploring the possibility of entering the Asset-Backed Securities market as well, thus the importance of securitization in lending activities cannot be ignored.

The second objective of the research was also fulfilled by the students as I was able to understand that and, in my opinion, there are four important steps, which are as follows:

- The purpose of a Special Purpose Vehicle is to hold title to the assets that underlie securities.
- The originator of the assets or the holder of the assets will sell the assets to the Special Purpose Vehicle.
- The Special Purpose Vehicle issues securities with the assistance of an investment

[17] Central Bank of India v. State of Kerala, (2009) 4 SCC 94.
[18] Transcore v. Union of India, (2008) 1 SCC 125.

banker, and these securities are then issued to investors; and

- The Special Purpose Vehicle uses the money it received from the sale of securities to make the payment to the originator for the assets. The originator receives immediate cash as a result of this transaction, which results in the financial asset being removed from the balance sheet of the originator, reducing constraints related to capital adequacy and allowing the originator to more effectively manage their capital.

The last two objectives regarding the challenges and recommendations of securitization have been achieved and shall be discussed in the forthcoming section.

VII. Certain challenges and recommendation

After conducting the above-mentioned research, the students have found certain challenges and recommend the following to have an efficient securitization in place:

There are several regulatory issues such as the issuance of high stamp fees, which sometimes, make the process unviable in certain states. Efforts should be made by the legislature to resolve this issue by setting an upper and lower limit for stamp fees.

There are currently no special regulations that regulate how SPVs in a securitization transaction recognise their respective incomes and are taxed accordingly. Provisions for taxation for Special Purpose Vehicles should be made under the ambit of SARFAESI.

There is always the risk of default or credit risk involved in the sense of non-repayment of the debt. Before giving the loans, the banks should holistically analyse the creditworthiness of the borrower so that no loss in the process occurs later.

The rights of several parties involved in the process of SARFEASI are not clearly defined under the act. Amendments should be made under the act to highlight the rights of the parties at various stages.

VIII. Conclusion

The conclusion of the above-mentioned discussion can be summarised by stating that the practice of liquidation of assets into marketable securities through the use of securitization has developed into an effective method for the liquidation of assets. In recent years, this sector has gained importance due to its benefit of permitting cash flow in the market, which in turn results in easy lending to the borrowers. Because of this advantage, this industry has become a key pillar in the banking business. The term securitization refers to a notion in finance that affects the economy. The regulations in sector become vital to encourage securitization during adverse occurrences, and in recent years, there have been various ups and downs in this sector, which caused the business to struggle to adapt to the adversity of the economy.

It is expected that securitization, which has become one of the most important developments in both global and national finance in recent decades, will continue to play a crucial role in the years ahead. The students concludes by stating that securitization refers to the process through which identical illiquid financial assets are pooled and repackaged into marketable securities that can be sold to investors. To strive as one of the most important pillars of the economy, all the challenges must be addressed so that more investors are willing to participate in the same for enabling cash flow in the economy.

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