Page 3158 - 3163 **DOI:** https://doij.org/10.10000/IJLMH.116494

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 6 | Issue 6

2023

Securitisation: Structure and Importance

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ABSTRACT

Securitisation implies every such process that converts a financial relation into a transaction, more specifically, into a capital market instrument or security. It is a process through which illiquid assets are packaged, converted into tradable securities and sold to third party investors. In securitisation process there are mainly two crafts: the original lender and a Special Purpose Vehicle (SPV). The SPV helps the original lender in liquefying the assets. The SPV converts these assets into marketable securities for investment and the cash flows to the original lender. This helps the original lender in meeting up the deficiency which arose out of the borrowers default. Apart from original lender and SPV, other parties involved in securitization process are merchant or investment banker, credit rating agency, servicing agency and the buyers of securities.

Keywords: *Non Performing Assets, securitization.*

I. INTRODUCTION

Securitisation implies every such process that converts a financial relation into a transaction, more specifically, into a capital market instrument or security. It is a process through which illiquid assets are packaged, converted into tradable securities and sold to third party investors. In securitisation process there are mainly two crafts: the original lender and a Special Purpose Vehicle (SPV). The SPV helps the original lender in liquefying the assets. The SPV converts these assets into marketable securities for investment and the cash flows to the original lender. This helps the original lender in meeting up the deficiency which arose out of the borrowers default. Apart from original lender and SPV, other parties involved in securitization process are merchant or investment banker, credit rating agency, servicing agency and the buyers of securities.

II. MAIN PLAYERS INVOLVED

Obligor: He can be any person who is customer for the originator. Who shallpay to originator for the goods and services taken from the originator on contractual basis?

Originator: This may be any entity, financial institutions or banks. Whose assets have been blocked. Originator sells his assets to the special purpose vehicle.

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Special purpose vehicle:-It is an entity which issues the bonds or securities for the assets of the originator. This entity is low cost and low capitalised entity which has some specific purpose. It purchases the assets from the originator and then securitised them, and makes the payment to the originator.

Investors:-The investors can be individuals, institutions for example financial institutions (FIS), mutual funds, insurance companies, pension funds, etc. 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.

Credit rating agencies:- These agencies ensures whether the payment of the loans will be pays timely or not and whether the loan is risky one or not. By this these agencies help in assessing the process of loan selection which are of appropriate credit worthiness and the extent to which such loan will be paid back or not to the investors and the strength of the legal framework.

III. How the process works

In the normal lending process, a bank finances a loan to the customers and in its balance sheet maintaining it as an asset than after sometime collects principal and interest and monitors whether there is any case of non-payment of the loan which will have a check on the borrower's creditworthiness.

The loan given by the bank is entitled to hold assets as the security in case of the default till maturity. Due to the reason that the funds are given to the customers, credit/liquidity of the banks to give loans to other customers get blocked and bank will face the lack of the funds. So banks need funds to meetsuch requirement. They do this generally by raising the funds from the marketso Securitisation is a process by which the banks can unlock these blocked funds.

Let's take an example, bank named POR Bank. This bank gives loan to its customer and charges some amount as interest which is further used by the ank to lend money in this way bank earns its profit. The loans given by the banks areassets which is shown in the asset side of the balance sheet because bank isentitled to principal amount and the interest on the loans .but for that time period the funds of the banks are locked and they are short of funds to lend further. The customers who have taken a loan from the POR bank are known as obligors.

Now the banks need cash to fund and give credit to other customers. Bank will transfer its assets to other company. In this case bank POR is originator and the company to whom these assets will be transferred is known as a special purpose vehicle (SPV).

The SPV is a separate entity it is registered under the companies act and has its work to buy these assets and to securitize the assets of the originator and facilitate funds to the originator..

Than securities are issued by these SPV to the investors which are known as pass-through-certificates (PTCs).investors are entitled to receive the cash flows i.e. the principal amount and the interest that obligor had to pay to the bank will be paid to the investor.

These PTC are riskier in nature as there will always be some chances that the customer will default in paying the loan amount. Though many steps could be taken to mitigate the risk but there will always be some chances of the default.

The persons or the entities who invest in the PTCs are known as QIBS. These QIBS may be any bank, financial institution, mutual funds, insurance companies, scheduled commercial banks etc. QIBS are always big players because they can only take such big risks.

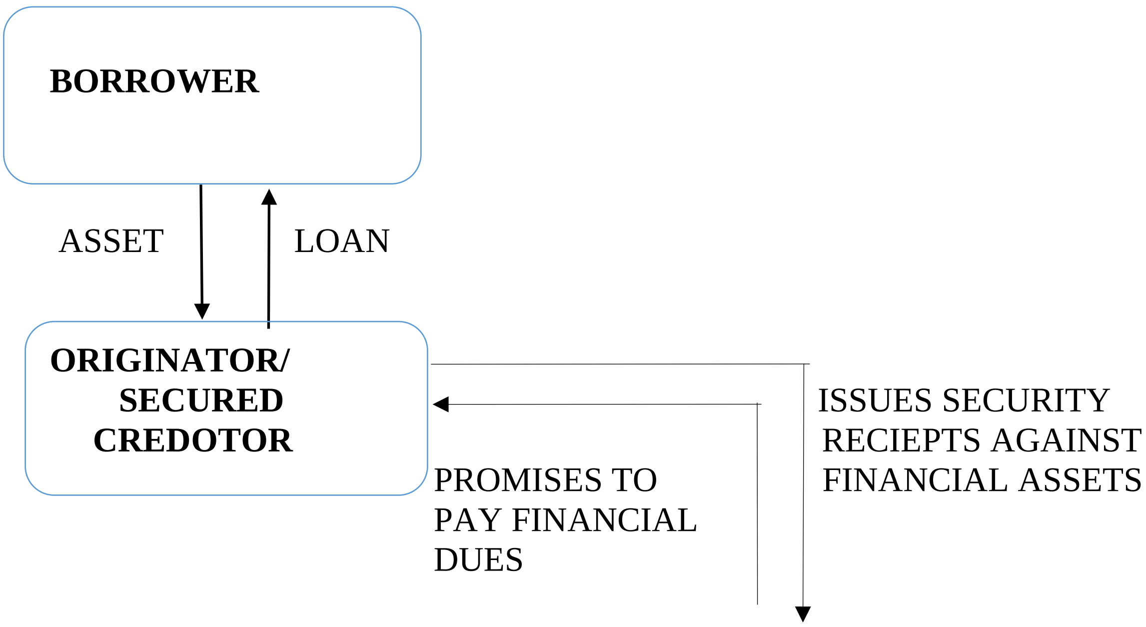
The rating agency plays a important role in which the agency rates the credit worthiness of the securitised instruments i.e. whether the securitized instruments are riskier one or not riskier one.

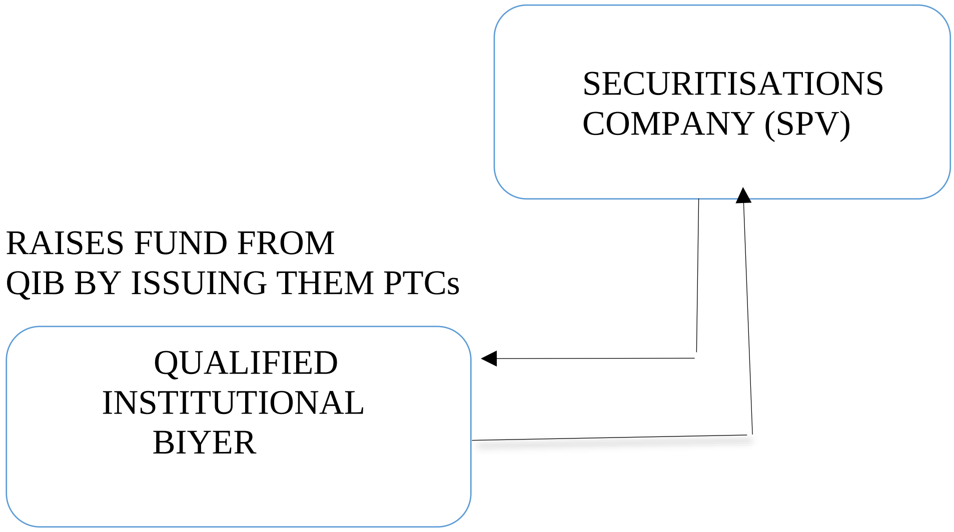
These companies rate the securitised instruments. The securities which are High rated will offer low risk and it will yield high to investors.

The servicer is appointed to collect the payments from the obligors. The servicer follows up with the defaulters and uses legal remedies against them.

When the assets of banks in their balance sheet get securitised by the SPVS they are removed from the bank's balance sheet and the proceeds of such generation of money by the banks can be used to give loans.

(FIGURE 1)





IV. Evolution of securitisation

The dawn of the concept of 'Securitisation can be traced to 1970 when the Government National Mortgage Association (GNMA) was created by the US government. Initially this model was dominated by home mortgages. However the US economy eventually took under its wings various other areas such as credit cards, student loans and other business loans.

UK recently witnessed the growth of securitisation and is the Second largest market for Securitization in the world. The first mortgag securitisation issue arranged in London for international market was MINI, a 50 million. refinancing of certain Bank of America Finance Limited U.K. property mortgages which was launched in January 1985. The credit for rapid expansion of asset securities in both USA and UK goes to their simple laws with respect to mortgage and debt securitisation.

European countries followed at a slower pace. Japan had till recently placed restriction on securitisation of assets however has now become more flexible post the amendment of 1997.

V. Securitisation in India

Securitisation is not an old rooted concept in India and still developing as compared to other countries like the U.S.A and U.K. where the concept is not only fully developed but also misused. The reason for the slow development of securitisation in India is the strict guidelines issued by the RBI which ended up taking the lucrative aspect of securitisation.

Thus what have lead to the slow development is the Indian government's policies and the indirect control it has exercised over the securitisation deals via the RBI.

The main broadly reported securitisation bargain in India goes back to 1990 when Citibank securitised Auto credits and set a paper with GIC Mutual asset, Singapore. From that point

 [ISSN 2581-5369]

forward, an assortment of arrangements has been embraced. There is no real information on the greatness of securitised obligation in India. Accessible information demonstrates that ICICI hadsecuritised resources for the tune of Rs.2, 750 crore in its books as at end March 1999. Advantages for the tune of Rs. 1,200 crore are currently being purchased over. CRISIL is accounted for to have appraised about Rs. 143 crores (Rs. 1,430 million) in 1996-97 to Rs. 2.902 crores (Rs. 29,020 million) in 1997-98. What's more there have been a few un-appraised exchanges.Various other corporations like Videocon Power, Larsen & Toubro, IDBI, Citibank and GIC Mutual Fund also bring into play this form of financing. The Karnataka Electricity with its act of securitising Rs. 194 crore worth of receivables to HUDCO Board has become the country's first entity to conclude a securitisation deal in the power sector.

Realizing the importance of the securitization market in India the legislature passed the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, so as to enforce financial discipline and control of the rights and obligations of its players.

This Act however cannot be read in isolation and needs to be examined in the light of the provisions of various laws like, The Transfer of Property Act1882, the Registration Act, 1908, the Indian Stamp Act 1899; Income Tax Act1961; Securities Contracts (Regulation Act) 1958 and SEBI Act 1992.

1. **Transfers of Property Act 1882-** Many of the recoverable are classified debts coming within the definition of immovable property and hence call for the knowledge on Transfer of Property Act.
2. **Registration Act, 1988**- According to section 17(1)d all non- testamentary instruments creating, declaring, assigning or extinguishing, whether in present or in future, any right title or interest, whether vested or contingent, of the value of 100 or above, to or in immovable property are required to be compulsorily registered. Securitisation involves creation and/or
3. **Securitization under SARFAESI Act: A Critical Analysis with reference to Recession** declaration of an interest in the immovable property firstly in favour of SPV and secondly in favour of the investors.
4. Indian Stamp Act, 1899 - According to section 2(10) of the Indian Stamp Act, conveyance includes conveyance on sale and other instruments relating to properties, movable or immovable. A conveyance attracts ad- valorem stamp-duty under Article 23 of Schedule I of the said Act.

5. The Income Tax Act, 1961 - The Act has several provisions relating to transfer of income. Sections 60, 160-162, 194A of the Act relate to matters involved in Securitisation.

6. Security Contracts (Regulations) Act, 1958 and Securities. Exchange Board of India Act, 1992 - All PTCs are securities under the ambit of the definition in the above two statutes. SEBI is empowered to regulate the issue of and trading in all PTCs.

(A) Importance

Some of the main advantages of securitisations are:

- It provides liquidity to the originators (non -banking financial companies/ banks) because it is concerned with the conversion of illiquid assets into liquid assts. The originator gets lump sum amount of money from the SPV or the trust to carry out its operations smoothly and in the absence of it, this money isto be realized in instalments over the years from the borrowers.
- Securitized debt is cheaper and with this deal the originator can beat the ratings given by the rating agencies and diversify the credit risk and
- Originators can plan their capital adequacy requirements by using securitization to reduce the risk weighted assets. These are requirements relating to minimum regulatory capital for financial intermediaries. Thus it allows the financial entity to sell off some of its on-balance-sheet assets thereby removing them from the balance sheet which ultimately results in reduction of in the amount of capital required for the regulatory purposes.

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