

Chapter 2 Meaning and Structure of Securitisation Transaction

2.1 Meaning

One of the most prominent developments in international finance in recent decades and the one that is likely to assume even greater importance in future, is securitisation. Securitisation is the process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool of assets. The pool of assets collateralises securities. These assets are generally secured by personal or real property (e.g. automobiles, real estate, or equipment loans), but in some cases are unsecured (e.g. credit card debt, consumer loans). There are four steps in a securitisation: (i) SPV is created to hold title to assets underlying securities; (ii) the originator or holder of assets sells the assets (existing or future) to the SPV; (iii) the SPV, with the help of an investment banker, issues securities which are distributed to investors; and (iv) the SPV pays the originator for the assets with the proceeds from the sale of securities. The touchstones of securitisation are:

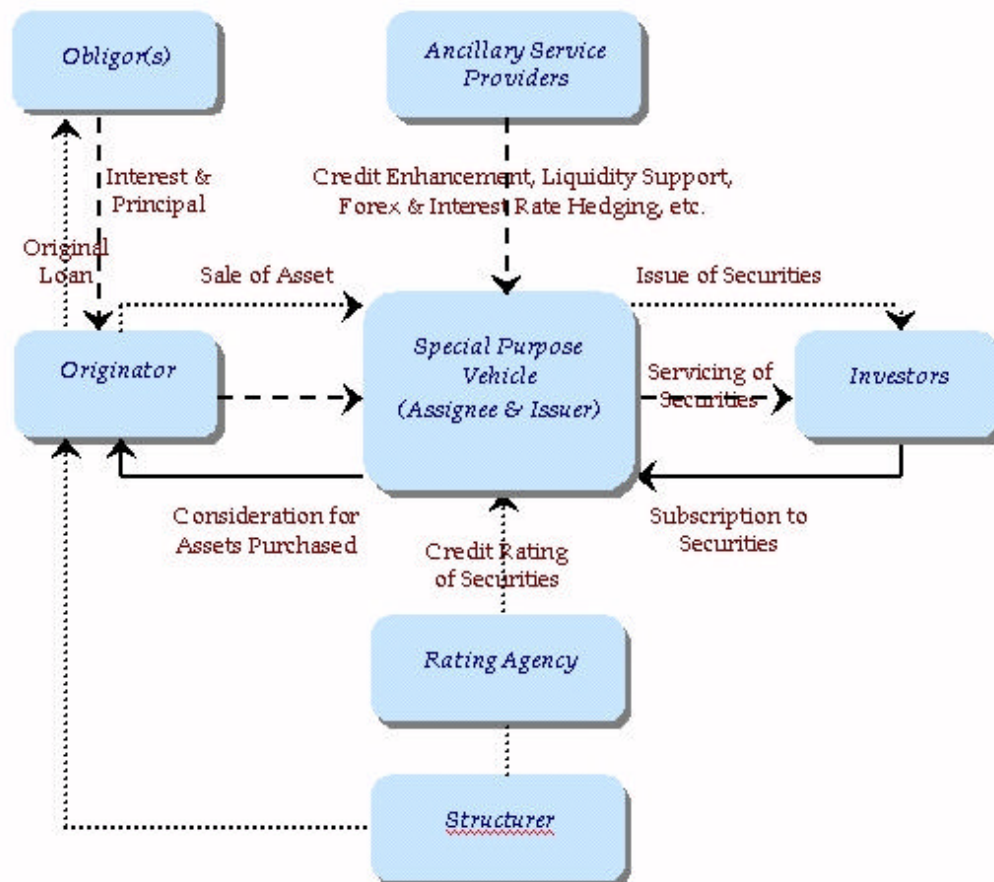
- Legal true sale of assets to an SPV with narrowly defined purposes and activities
- Issuance of securities by the SPV to the investors collateralised by the underlying assets
- Reliance by the investors on the performance of the assets for repayment - rather than the credit of their Originator (the seller) or the issuer (the SPV)
- Consequent to the above, “Bankruptcy Remoteness” from the Originator

Apart from the above, the following additional characteristics are generally noticed:

- administration of the assets, including continuation of relationships with obligors
- support for timely interest and principal repayments in the form of suitable credit enhancements
- ancillary facilities to cover interest rate / forex risks, guarantee, etc.
- formal rating from one or more rating agencies

A securitisation transaction generally involves some or all of the following parties: (i) the initial owner of the asset (the originator or sponsor) who has a loan agreement with the borrowers (obligors); (ii) the issuer of debt instruments who also is the SPV. The structure keeps the SPV away from bankruptcy of the originator, technically called ‘bankruptcy remote’; (iii) the investment bankers who assist in structuring the transaction and who underwrite or place the securities for a fee; (iv) the rating agencies, who assess credit quality of certain types of instruments and assign a credit rating; (v) the credit enhancer, possibly a bank, surety company, or insurer, who provides credit support through a letter of credit, guarantee, or other assurance; (vi) the servicer, usually the originator, who collects payments due on the underlying assets and, after retaining a servicing fee, pays them over to the security holders; (vii) the trustee, who deals with issuer, credit enhancer and servicer on behalf of the security holders; (viii) the legal counsel, who participates in the structuring of the transaction¹; and (ix) the swap counterparty who provides interest rate / currency swap, if needed. A typical securitisation structure is given below.

Figure 1 Typical Securitisation Structure



Note: Continuing flow of funds from the Obligor to the SPV is routed through the Originator in its capacity as administrator. Any other party appointed by the SPV/Trustee can also perform the role of administrator. It is also possible that the SPV receives the amounts directly from the Obligor(s).

2.2 Parties to a Securitisation Transaction

There are primarily three parties to a securitisation deal, namely -

- a. **The Originator:** This is the entity on whose books the assets to be securitised exist. It is the prime mover of the deal i.e. it sets up the necessary structures to execute the deal. It sells the assets on its books and receives the funds generated from such sale. In a true sale, the Originator transfers both the legal and the beneficial interest in the assets to the SPV.
- b. **The SPV:** The issuer also known as the SPV is the entity, which would typically buy the assets (to be securitised) from the Originator. The SPV is typically a low-capitalised entity with narrowly defined purposes and activities, and usually has independent trustees/directors. As one of the main objectives of securitisation is to remove the assets from the balance sheet of the Originator, the SPV plays a very important role in as much as it holds the assets in its books and makes the upfront payment for them to the Originator.
- c. **The Investors:** The investors may be in the form of individuals or institutional investors like FIs, mutual funds, provident funds, pension funds, insurance companies, etc. They buy a participating interest in the total pool of receivables and receive their payment in the form of interest and principal as per agreed pattern.

Besides these three primary parties, the other parties involved in a securitisation deal are given below:

- a) **The Obligor(s):** The Obligor is the Originator's debtor (borrower of the original loan). The amount outstanding from the Obligor is the asset that is transferred to the SPV. The credit standing of the Obligor(s) is of paramount importance in a securitisation transaction.
- b) **The Rating Agency:** Since the investors take on the risk of the asset pool rather than the Originator, an external credit rating plays an important role. The rating process would assess the strength of the cash flow and the mechanism designed to ensure full and timely payment by the process of selection of loans of appropriate credit quality, the extent of credit and liquidity support provided and the strength of the legal framework.
- c) **Administrator or Servicer:** It collects the payment due from the Obligor/s and passes it to the SPV, follows up with delinquent borrowers and pursues legal remedies available against the defaulting borrowers. Since it receives the instalments and pays it to the SPV, it is also called the Receiving and Paying Agent.
- d) **Agent and Trustee:** It accepts the responsibility for overseeing that all the parties to the securitisation deal perform in accordance with the securitisation trust agreement. Basically, it is appointed to look after the interest of the investors.
- e) **Structurer:** Normally, an investment banker is responsible as structurer for bringing together the Originator, credit enhancer/s, the investors and other partners to a securitisation deal. It also works with the Originator and helps in structuring deals.

The different parties to a securitisation deal have very different roles to play. In fact, firms specialise in those areas in which they enjoy competitive advantage. The entire process is broken up into separate parts with different parties specialising in origination of loans, raising

funds from the capital markets, servicing of loans etc. It is this kind of segmentation of market roles that introduces several efficiencies securitisation is so often credited with. More details of various agencies are given in Chapter 8.

2.3 Pass and Pay Through Structures

The nature of the investors' interest in the underlying assets determines whether a securitisation structure is a 'Pass Through' or 'Pay Through' structure. In a pass through structure, the SPV issues 'Pass Through Certificates' which are in the nature of participation certificates that enable the investors to take a direct exposure on the performance of the securitised assets. Pay through, on the other hand, gives investors only a charge against the securitised assets, while the assets themselves are owned by the SPV. The SPV issues regular secured debt instruments. The term PTCs has been used in the report referring to pass through as well as pay through certificates.

Pay through structures permit de-synchronization of servicing of the securities from the underlying cash flows. In the pay through structure, the SPV is given discretion (albeit to a limited extent) to re-invest short term surpluses - a power that is not available to the SPV in the case of the pass through structure. In the pass through structure, investors are serviced as and when cash is actually generated by the underlying assets. Delay in cash flows is of course shielded to the extent of credit enhancement. Prepayments are, however, passed on to the investors who then have to tackle re-investment risk. A further advantage of the pay through structure is that different issues of securities can be ranked and hence priced differentially.

2.4 Asset and Mortgage Backed Securities

Securities issued by the SPV in a securitisation transaction are referred to as Asset Backed Securities (ABS) because investors rely on the performance of the assets that collateralise the securities. They do not take an exposure either on the previous owner of the assets (the Originator), or the entity issuing the securities (the SPV). Clearly, classifying securities as 'asset-backed' seeks to differentiate them from regular securities, which are the liabilities of the entity issuing them.

In practice, a further category is identified – securities backed by mortgage loans (loans secured by specified real estate property, wherein the lender has the right to sell the property, if the borrower defaults). Such securities are called Mortgage Backed Securities (MBS). The most common example of MBS is securities backed by mortgage housing loans. All securitised instruments are either MBS or ABS.

2.5 Credit Enhancement

Investors in securitised instruments take a direct exposure on the performance of the underlying collateral and have limited or no recourse to the Originator. They hence seek additional comfort in the form of credit enhancement, a term used to describe any of the various methods by which risks intrinsic to the transaction are re-allocated. Put simply, it refers to any of the various means that attempt to buffer investors against losses on the assets collateralising their investment. These losses may vary in frequency, severity and timing, and depend on the asset characteristics, how they are originated and how they are administered. Credit enhancements are often essential to secure a high level of credit rating and for low cost funding.

By shifting the credit risk from a less-well-known borrower to a well-known, strong, and large credit enhancer, credit enhancement corrects imbalance of information between lender and borrower. Credit enhancements are either external (third party) or internal (structural or cash-flow-driven). Various kinds of credit enhancements are elaborated below:

i) External Credit Enhancements

Insurance: Full insurance is provided against losses on the assets. This tantamounts to a 100 per cent guarantee of a transaction's principal and interest payments. The issuer of the insurance looks to an initial premium or other support to cover credit losses.

Third party guarantee: This method involves a limited/full guarantee by a third party to cover losses that may arise on non-performance of the collateral.

Letter of credit: For structures with credit ratings below the level sought for the issue, a third party provides a letter of credit for a nominal amount. This may provide either full or partial cover of the issuer's obligation.

ii) Internal Credit Enhancements

Credit Tranching (senior/sub-ordinate structure): The SPV issues two (or more) tranches of securities and establishes a pre-determined priority in their servicing, whereby first losses are borne by the holders of the sub-ordinate tranches (at times the Originator itself). Apart from providing comfort to holders of senior debt, credit tranching also permits targeting investors with specific risk-return preferences.

Over-collateralisation: The Originator sets aside assets in excess of the collateral required to be assigned to the SPV. Cash flows from these assets must first meet any overdue payments in the main pool, before they can be routed back to the Originator.

Cash collateral: This works in much the same way as the over-collateralisation. But since the quality of cash is self-evidently higher and more stable than the quality of assets yet to be turned into cash, the quantum of cash required to meet the desired rating would be lower than asset over-collateral to that extent.

Spread account: The difference between the yield on the assets and yield to the investors from the securities is called excess spread. In its simplest form, a spread account traps the excess spread (net of all running costs of securitisation) within the SPV up to a specified amount sufficient to satisfy a given rating or credit quality requirement. Only realisations in excess of this specified amount are routed back to the Originator. This amount is returned to the Originator after the payment of principal and interest to the investors.

Triggered amortisation: This works only in structures that permit substitution (for example, rapidly revolving assets such as credit cards). When certain pre-set levels of collateral performance are breached, all further collections are applied to repay the funding. Once amortisation is triggered, substitution is stopped and the early repayment is an irreversible process. Triggered amortisation is typically applied in future flow securitisation.

2.6 Future Flow Securitisation

2.6.1 Introduction

A future receivable securitisation, as the term implies, raises funds based on expected future cash flows that have not, at the close of the transaction, been generated². These types of transactions can be split into two distinct areas: long term contract receivables and future cash flows. Examples of long term contract receivables would be term off-take agreements for the supply of goods or services such as the export of commodities (e.g. oil, coffee or steel) or payment for clearing services. In this category the volume of the receivables will be known or at least be set at a minimum. However, the price of the receivables may be variable. To the extent that the receivables are generated from the sale of commodity/product there may be an opportunity to provide some type of price floor through the use of hedging instruments. The future cash flow category would include receivables that are not only subject to price variations but also to variations in volume (i.e., there is no minimum contracted volume). These would include telecom receivables, ticket receivables and worker remittance payments. All these categories will have no minimum volumes over the life of the issue but will depend on both the performance of the seller and macro-economic events. In

these cases the rating agencies will assume a base case for the volume of receivables over the life of the transaction. This will then be subjected to stressing either by applying an over-collateralisation multiple or by reducing the base case cash flows progressively over a number of years. This cash flow is then assigned as collateral for the repayment of debt instruments sold in the capital markets. The nature of that cash flow, taken together with a string of other structural credit enhancements, generally ensures that the transaction is rated above the unsecured debt ratings of the borrower. As a result, under a securitisation transaction, the borrower is able to achieve finer pricing and/or longer tenors than is otherwise available from other funding sources.

2.6.2 Asset Classes Securitised

ABSs have been constructed based on future income streams that arise from the use of physical assets (e.g. telecommunication network, toll charges on roadways), income arising due to regulations (e.g. revenue taxes of municipal authorities), income from sale of natural resources (e.g. oil and natural gas), etc. Historically, five types of asset classes have generated the bulk of future flow securitisation. These are:

- i) Exports of commodities or commodity-like products
- ii) Credit card receivables (generated from the use of Visa and MasterCard credit cards by tourists in the host country)
- iii) Telephone toll receivables arising from international traffic service
- iv) Workers' remittances; and
- v) Project finance based transactions.

With respect to export securitisation, transactions have been concluded for Oil, Gas, Copper, Aluminum, Steel, Pulp, Energy, Gold, Silver, Diamonds, Orange juice, Soybean, Wheat, even Fish etc. Less important classes include airline ticket sales, airport landing fees and the export of semi-finished goods.

2.6.3 Motives for Future Flow Securitisation

(a) Cost of Funds: The most convincing argument to borrowers as to why to engage in future flow securitisation remains cost of funds. Most future flow securitisation achieves significantly higher ratings than unsecured "vanilla" corporate debt. This rating improvement usually results in lower spreads to the borrower. The exact benefit, however, can be sometimes difficult to demonstrate. This is because, in many cases, the borrower does not or cannot issue long dated corporate bonds.

(b) Diversification of Funding Sources: Just as important as reducing cost of funds is diversifying access to funding sources. Many borrowers in the emerging markets (EMs) rely heavily on either bank financing or unsecured bonds. Yet, in times of financial crises, these funding sources can quickly dry up. The perceived higher quality of the securitised transactions ensures that investor demand will continue for the paper, even in time of great stress. A good example of this is the Mexican Peso crisis of 1994. Notwithstanding the liquidity crisis in Mexico, and the tremendous stress that the financial sector underwent, Mexican banks were able to access seven-year money based on securitisation of their Visa and Master Card receipts.

(c) Longer Tenure: Securitisation can serve to extend the tenure of financing available to borrowers. Depending on the asset class, tenures of up to 30 years can be achieved. Longer dated transactions are generally available for securitisation supported by oil, gas or minerals.

(d) Limited Recourse: Many securitisations are structured as a sale to investors of future receivables. The recourse to the borrower in the event that such receivables are not generated or collected, or the product is not delivered can be limited. Both investors and rating agencies assess the strength of the transaction, taking into account such risks. Given that in

many instances the future assets or cash flow being securitised is the highest quality of assets that a borrower may have, general recourse is not considered to enhance the transaction from a credit perspective. Instances where recourse will, however, be required include non-performance by the borrowers of their obligations (or covenants) under the transaction, a loss of the rights of the investors in the asset and bankruptcy proceedings.

2.6.4 Risks

(a) Bankruptcy / Performance Risk: Since future flow transactions rely on the future generation of cash flow to repay investors, the continued existence and performance of the borrower throughout the tenure of the transaction are critical considerations to investors. Indeed, this risk generally acts as the limiting constraint on the rating of the transaction and consequently determines the tenure as well as the pricing.

The ultimate rating may be enhanced by at most one notch above the local currency rating of the borrower in case the securitisation constitutes a true sale transaction under the bankruptcy laws of the borrower. In other words, should the borrower become insolvent, no creditors of the borrower would be able to make a claim against the receivables sold to investors. So long as the borrower continues to operate (even in bankruptcy), investors will receive payments on the receivables on time and unhindered. In terms of mitigating this risk, there is very little that can be done structurally without obtaining the support or guarantee of a rated third party.

(b) Generation Risk: There still is another risk related to the sustained generation of the receivables at certain levels from a host of factors outside of the control of the borrower, e.g. anticipated reserves may not materialise or seasonal variations in the anticipated levels of receivables may occur. This risk is mitigated through adequate over-collateralisation. Further, in order to protect investors against more sustained long-term declines in the levels of receivables generated, early amortisation triggers are usually built into the transaction that will trigger the repayment of the securities on an accelerated basis if a predefined trigger level is breached.

(c) Price Risk and Off-take Risk: These refer to likely price variations or the concern that the Obligors in the future cease buying or reduce their purchasing level of the goods or service from the seller.

2.6.5 Other Considerations

(a) True Sale: There are some questions related to whether sale of receivables yet to be generated is legal, valid and binding and cannot be disrupted by a liquidator of the seller in bankruptcy. In many jurisdictions including the US, such sales are not enforceable. However, many other jurisdictions, such as Mexico, Brazil or Turkey do allow for such a true sale of future receivables. In India too, at present, it is difficult to perfect the security interest in respect of future receivables for the benefit of the investors and ultimately transactions may have to be structured with some recourse to the Originator in events of default.

(b) Negative Pledges: Investors cannot have a general recourse to the seller for all events leading to a shortage in cashflow from the receivables. They may only have recourse in situations that were under the control of the seller (such as failing to produce the goods or services in sufficient volumes). Events deemed outside the control of the seller are price risk, liquidity risk and credit risk. These risks can be mitigated somewhat by the techniques discussed above but ultimately, they must lie with the investors in all securitisation transactions whether of existing receivables or of future flows.

(c) Accounting Treatment: Though a future flow securitisation may not always be treated as debt for regulatory, negative pledge or tax purposes, it almost always has to appear as a

liability on the balance sheet of the seller. This is because the seller is selling "future" assets that were not on the balance sheet on the closing date of the transaction. The seller will receive the principal amount of the transaction as cash, and a corresponding entry has to be made on the liability side of the balance sheet that reflects the seller's obligations to deliver future goods or services to the SPV.

2.6.6 Indian context

According to one view, future flow receivables of export / petroleum / oil exploration etc. are not considered suitable for securitisation at present in India for the following reasons:

- It is a relatively recent phenomenon even in the international market and is fraught with risks, which revolve around the definition; ascertainability and quantifiability of securitisable cash flows. Such risks may not be well understood by investors. FIs need to develop the required competence in analysis of such risks before getting themselves exposed.
- Repayment to investors out of future sales could erode the current assets hypothecated to working capital bankers or the capacity of the Originators to service term loans / meet other pressing obligations.

Therefore, extreme caution is called for when the financial institutions book assets based on future cash flow or they guarantee the repayment of the underlying obligations. However, there is huge potential for securitising future receivables in infrastructure sector in India as detailed in Chapter 4.

¹ Shenker Joseph C and Colletta Anthony J., 'Asset Securitisation Evolution: Current Issues and New Frontiers'. In *Texas Law Review*, 69:1369 (1991) p.1374

² International Securitisation – ABN Amro May 1998.