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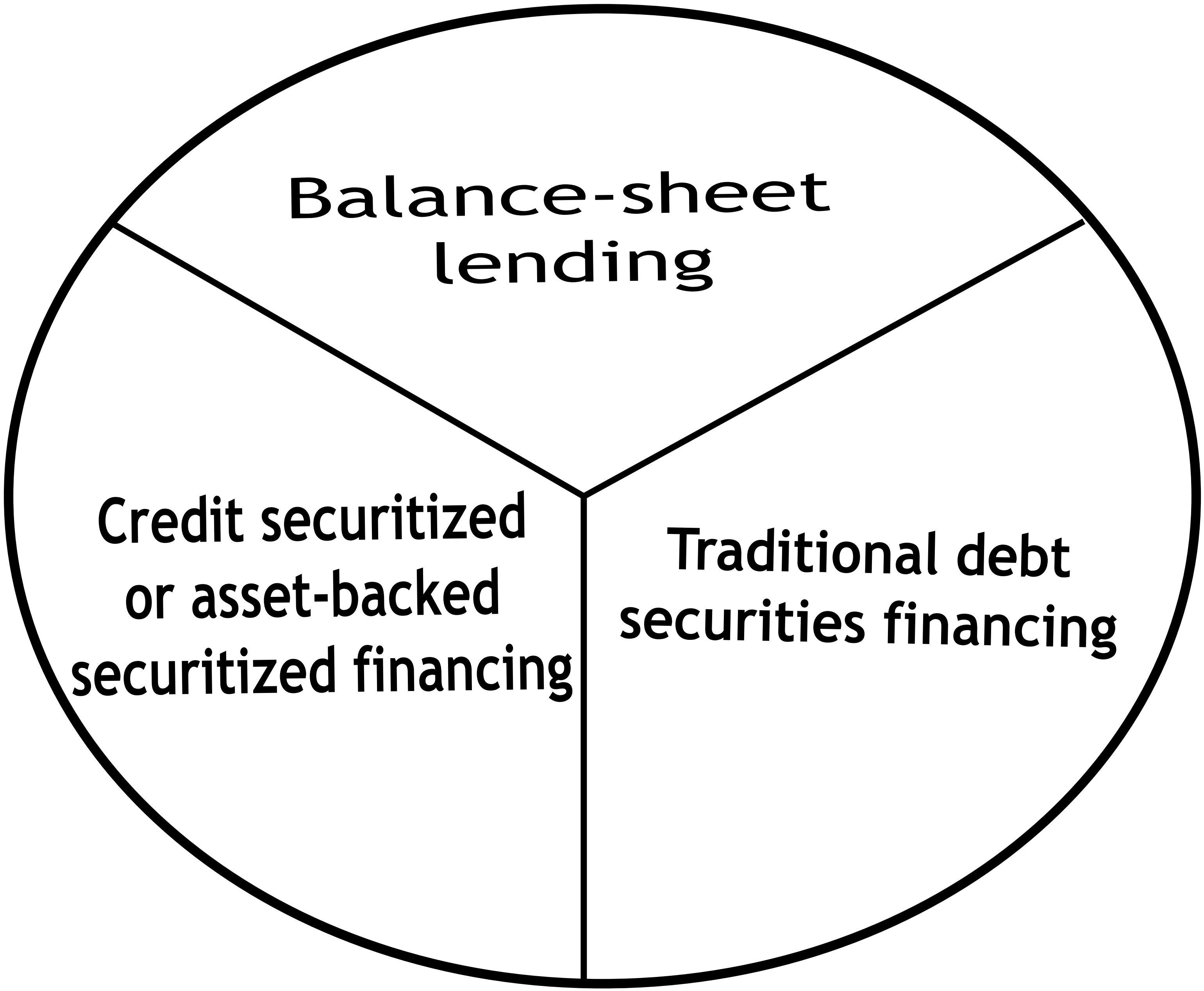
Three fundamental techniques for debt financing



Securitization

Securitization constitutes a key segment of structured finance.

But what do we mean by structured finance?

Structured finance, in simple terms, is a financial technique whereby a deal, contract, or product is designed, customized, or engineered (structured) to meet customers' specific financial or investment objectives and risk-taking ability.

Securitization defined

Securitization is a technique by which identified receivables and other financial assets are converted into marketable securities and sold to investors.

The instruments issued under a Securitization deal derive their value from the cash flows (current or future) or collateral value of a specified financial asset or pool of financial assets, general debt obligations, or other financial receivables.

Myth about Securitization

Contrary to common understanding, "hard" assets do not serve as the primary collateral for securitizations. Only contracts, such as leases, mortgages, loans, and agreements that define payment obligations create the contractual cash flows necessary for securitization.

What does it imply?

The specific values ascribed to real estate, companies such as telecom, electricity, offering services on a subscription basis, leased assets such as planes, ships, etc., derive from the <u>quality of the underlying cash flows</u>, not the other way around.

Classification of Securitization

Asset-backed securitization

Securitization of receivables that are existing i.e. obligation of the obligor to make payments is not dependent on further action or performance by the originator.

Classification of securitization

Future flow securitization

Securitization of receivables that are to be generated in the future, that is, the obligation of the obligor to make payments depends on further substantial performance by the originator.

Classification of securitization

Future flow Securitization

In a typical future flow transaction, the borrowing entity (originator) in a developing country sells its future products (receivables) directly or indirectly to an offshore special purpose vehicle/entity (SPV/SPE), which issues the debt instrument. designated international customers (obligors) are directed to pay for the goods they import from the originator directly into an offshore collection account managed by a trustee.

The collection agent makes principal and interest payments to lenders, and any funds left over are forwarded to the originator.

Raw material for securitization

<u>Any resource with predictable cash flows</u>.

Examples are:

- Mortgage loan
- Auto loan,
- Educational loan receivables
- Credit card receivables
- Lease receivables
- Telecom receivables,
- Electricity/power receivables,
- Export receivables,
- Advertising commission receivables

Raw material for future flow securitisation

Ranking of future flow-backed transactions from most secure to least secure

- Heavy crude oil receivables
- Airline ticket receivables
- Telephone receivables, credit card receivables and electronic remittances
- Oil and gas royalties
- Export receivables
- Paper remittances
- Tax revenue receivables

Key Drivers of Securitization Market in India

Transaction structures, choice of asset class, etc., are driven by regulatory prescription.

Originator:

- **Capital relief**
- **Pricing benefit**
- **Alternate funding source**
- **Managing exposure norms**

Investors:

- **Plugging PSL (priority sector lending) shortfall**
- **Better credit quality than Originators in some cases**
- **Possibility of customizing underlying loan pool**

Originator and Investors in India

Originators and investor classes in India have been restricted to:

- Banks
- Both public and private sector banks
- Non-bank financial institutions
- Housing finance companies
- Microfinance companies
- Mutual funds

Insurance companies are also permitted to invest in ABS, however, they have stayed away from the market mostly.

The limited investors class has been a limiting factor in the growth of securitization in India

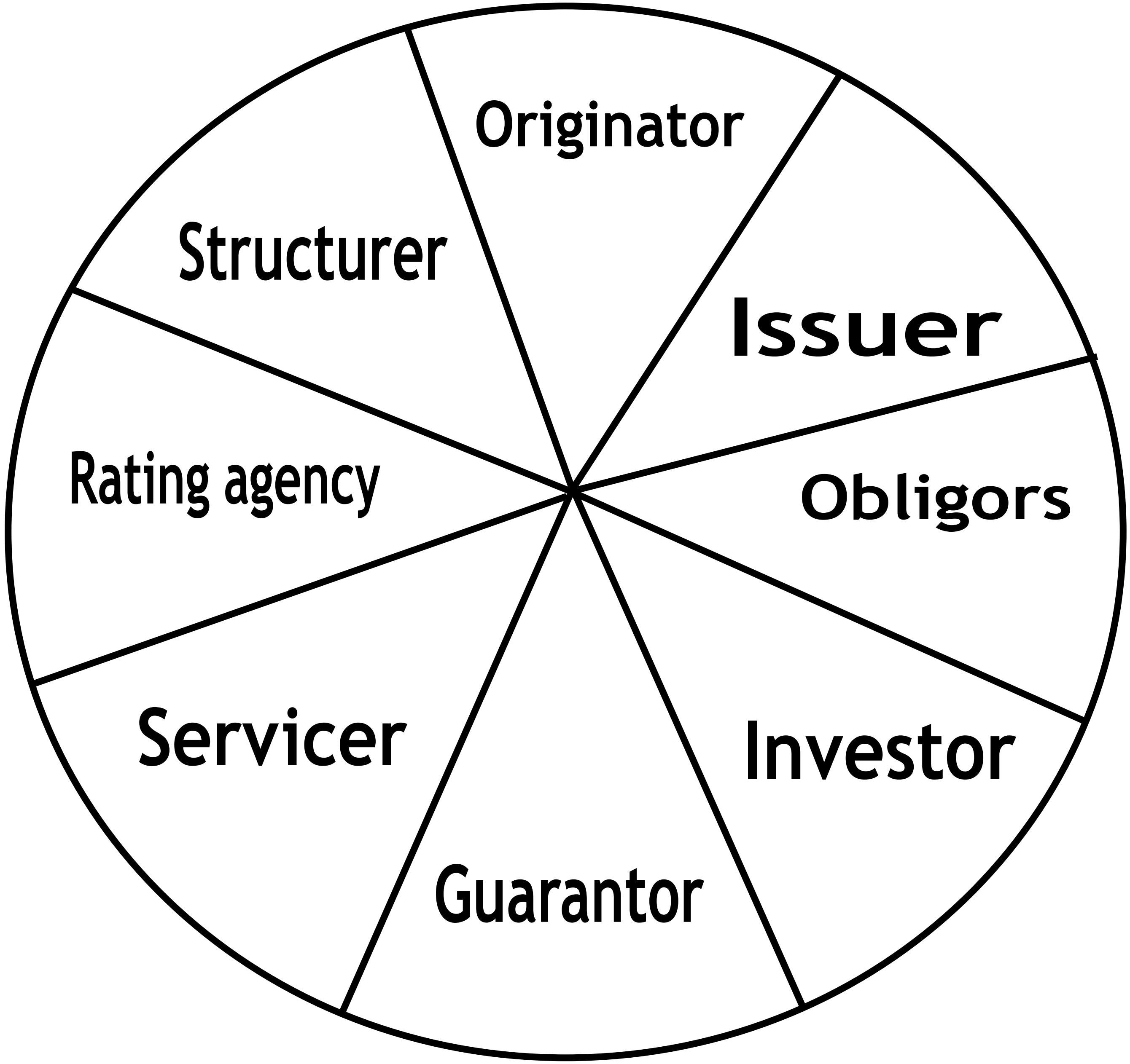
Impact of Securitisation on Originator

- Not exposed to credit or interest rate risk
- Net income would be closed — due to originating and servicing fees as well as the excess spread.
- Cash flows improve.
- Better utilization of capital and infrastructure
- Improves ROA/ROE

Securitization essentials

- Good credit ratings
- Attractive coupon rates
- Stable cash flow
- Liquid secondary market; and
- Range of maturities

Parties to securitization Deal



Securitization mechanism

Origination: Assets are originated through receivables, leases, housing loans, or any other form of debt

Structuring:

- Pooling of cash flows from assets: The accounts in the pool are analyzed to understand.

  -Divergence of the pool from the portfolio with respect to geographic distribution, the ticket size of the loan, loan to value ratios.

  -Parameters such as customer concentration (by amount) can be a critical factor in the pool quality

  -The type of asset being financed.

  -Pool seasoning: With seasoning, the equity of the borrower in the asset being financed increases and it is expected that loss rates will reduce with higher seasoning.

Securitization mechanism

Structuring:

- Pooling of cash flows from assets: The accounts in the pool are analzsed to understand.

  -Prepayments: Prepayments can increase for assets such as CVs at a higher rate during the life of the loan

  -Holding Period and Retention Period

  -Delinquency Profiles across Ageing Buckets

- Repackaging and transfer of assets (receivables in favour of trust or a special purpose vehicle*
- Creation of securities out of SPV/SPE assets.

Securitization mechanism

<u>*SPV</u>:

-Special purpose vehicle/Entity is established solely to acquire assets and issue debt secured by those assets.

-SPV, also called the “issuer,” purchases a specific pool of assets and nearly simultaneously issues debt securities—the asset-backed securities—and equity interests to fund the purchase of those assets.

Securitization Structures in India

There are two securitization structures prevalent in India:

- Bilateral assignments, also called direct assignments
- Probably the only country, where assignment of receivables is called securitization
- Securitization using the SPV structures, also called PTC (pass-through certificates) structures

- Securitization is largely a device for bilateral acquisition, in India

- Dominant in the Indian market, around 80% of securitization is bilateral assignment

Securitization mechanism

<u>**Credit enhancement:**</u>

- For obtaining an investment rating
- Making the transaction attractive for investors
- Obtaining credit support by a pool insurance policy- typically in the form of a first loss guarantee from the originator of the primary assets and then a wrap guarantee
- Credit enhancement through a letter of credit or insurance to increase their attractiveness to the investors

Securitization mechanism

<u>Placement</u>+: Issue of securities managed by an investment banker who may underwrite the whole issue or it may be a syndicate of merchant bankers

+ Points considered by investment bankers

- Asset portfolio must have a documented history (showing loss/delinquency experience)
- Historical loss to be modest
- Assets must have originated from standardized contracts
- Asset portfolio to be so structured that risk is well-diversified, say by the use of tranching of securities.

Securitization mechanism

Often, but not always, the SPV issues multiple classes of debt with different priorities of payment, which are called tranches.

Tranching of Securities

Senior Investors

⬇

Senior Tranche

- Highest rating
- Lowest interest
- Priority in repayment

Mezzanine Investors

⬇

Mezzanine Tranches

- Rating, interest and ranking between subordinated and senior tranches

Subordinated Investors

⬇

Subordinated Tranche

- Low or no rating
- Highest interest
- Rank last in repayment
- First to absorb loss

Issue Securities and Receive Purchase price

⬆

SPV

Example of Tranching of Securities

Let’s say we have 10,000 car loans with a balance of ₹100 million. If we just held on to the car loans we would take a loss every time there was a loss on an auto loan. But let’s say we turn the auto loans into two securities:

Security A has a balance of ₹90 million
Security B has a balance of ₹10 million

Let’s say that we then allocate any losses on the auto loans to B first. This way, Security A is less risky than Security B.

Securitisation mechanism

Administration: The originator continues to administer the loan portfolio for some fee and passes the collections to the trust or special purpose vehicle that serves the securities

Listing and trading:

- Securities usually enjoy a high degree of liquidity
- Investment /Merchant banker acts as a market maker to perform buying and selling functions

Illustration of the process of securitization

Originator	Indiabulls Housing Finance Limited (IBHFL)
Transaction	Pass-Through Certificates (PTCs): Series A PTCs (Senior PTCs) of Rs.900.72 Crores, amortizing in 4 years, and Series B PTCs (Junior/Subordinated PTCs) of Rs. 485 crores, maturity 05 March 2061 (Total Rs. 1385.72) backed by housing loans and loans against property receivables originated by IBHFL.
Pool Characteristics	The selected pool consists of loan receivables pertaining to housing loans against residential properties (95% of the pool) and loans against properties (LAP) (5% of the pool). Underlying loans have monthly repayment frequency and service the interest on a monthly basis. The average outstanding loan in the pool is Rs.32.16 lakhs with a seasoning of 41 months and an average tenure of 21 years. All the contracts in the pool are current as on the pool cut-off date with average CIBIL score of 759. (A score ranging between 650 and 749 is considered good and lenders may offer you a home loan after inquiring into your other financial details.)

Illustration of the process of securitization…Cont.

Issuer (SPV)	Retail Securitization Opportunist Trust (RSOT)
Trustee	Catalyst Trusteeship Limited (CTL)
Servicer	IBHFL
Rating Agency	Brickwork Ratings (BWR)
Ratings	Series A PTCs (Senior PTCs): BWR A (SO) Stable Series B PTCs (Junior/Subordinate PTCs: BWR (SO) Stable
Credit enhancement	First Loss Credit Facility (FLCF) of Rs. 90 Crores available in the form of fixed deposits (10% of senior PTCs) with ICICI Bank by the originator (IBHFL).
Investors	Series A PTCs: Subscribed by Davidson Kempner Asia Ltd.(DKAL) Series B PTCs by the Originator.
Payment Mechanism	Senior PTCs shall be paid first and once it is fully amortized, the Junior PTCs shall start receiving payments or if there are excess cash flows available after servicing senior PTCs.

Source: Brickwork Ratings, Rating Rationale, 3 Feb. 2021

IBHFL Securitization deal structure

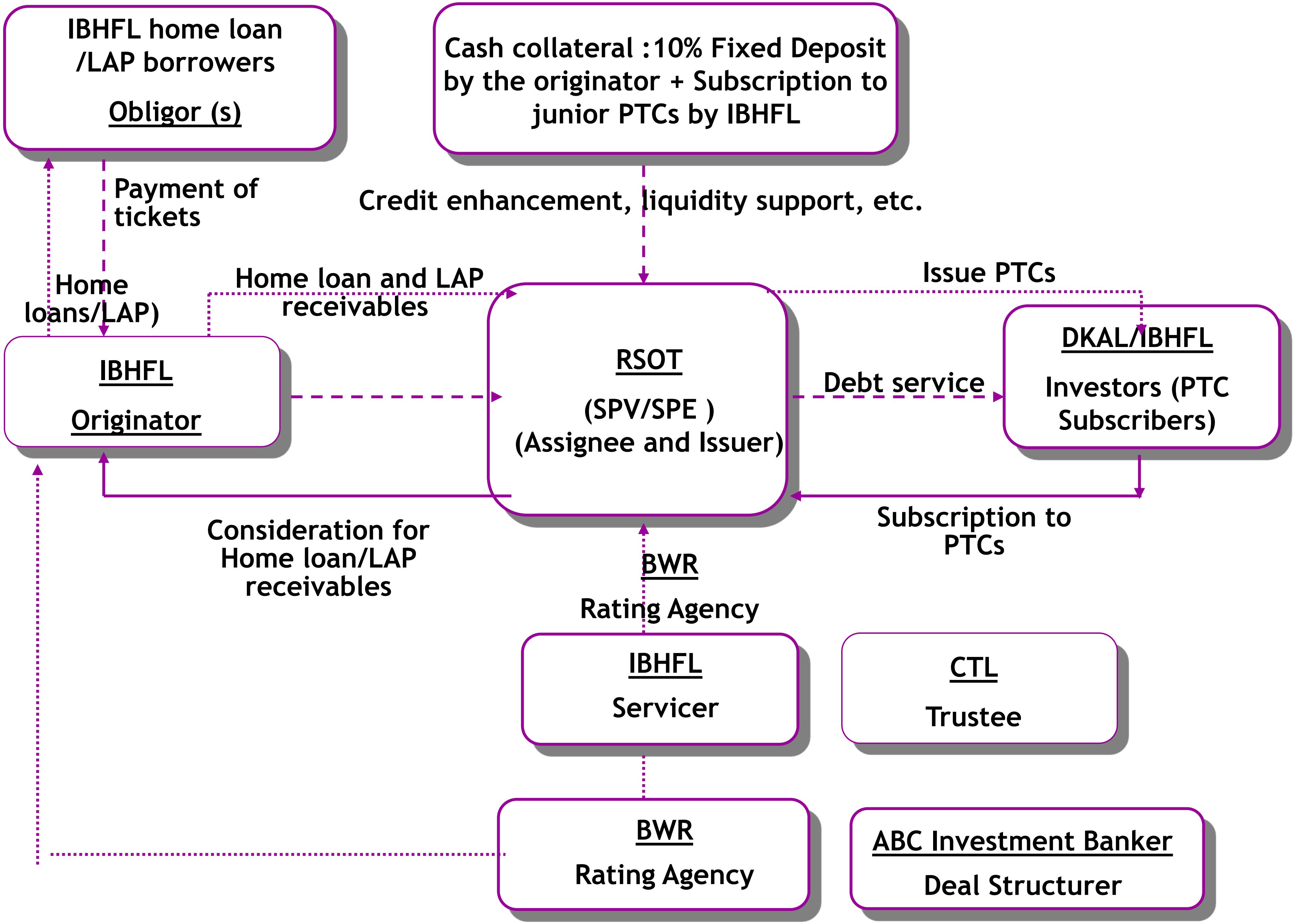


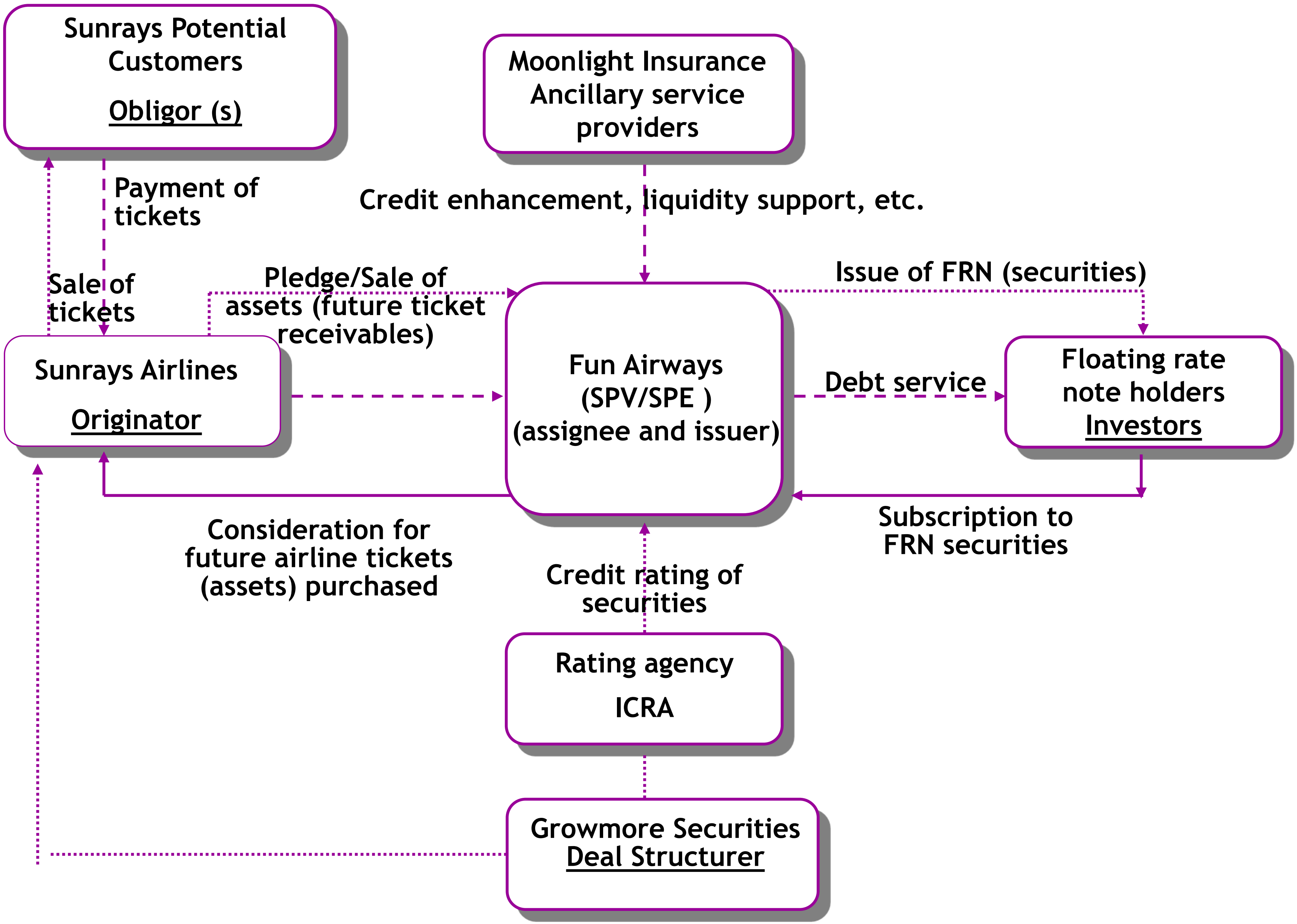
Illustration of the process of securitization

Originator	Sunrays Airlines Limited
Collection agent	Sunrays Airlines Limited
Transaction	Ticket receivables airline future flow securitization bonds ₹600 crore three-tranche floating rate notes, legal maturity 2022, average life 4.2 years
Issuer (SPV/SPE)	Fun Airways Limited
Arranger	Growmore Securities Limited
Due Diligence	The arranger will undertake due diligence on assets to be securitized. For this, it will examine the Sunrays performance over the last six years, as well as model future projected figures, including: • Total passenger sales • Total ticket sales • Total credit card receivables • Geographical split of ticket sales Being future flow of receivables, the credit card purchases of airline tickets are being securitized. It is considered a higher-risk asset class because the airline industry has a tradition of greater volatility of earnings

Illustration of the process of securitization…Cont.

Marketing approach	Present and all future credit card ticket receivables generated by the Sunrays will be transferred to an SPV/SPE, Fun Airways Limited, The investment bank’s (Growmore Securities) syndication desk will seek to place the notes with institutional investors say mutual funds across India. Notes are initially given indicative pricing ahead of the issue, to gauge investor sentiment. Given the nature of the asset class, the notes will be marketed at around SBI MCLR plus 450 basis points. Notes are benchmarked against recent issues with similar asset classes, as well as the spread level in the unsecured market of comparable issuer names.
Credit rating	AA /ICRA- Rationale: (i) Sunrays historical financial performance, including its liquidity and debt structure; (ii) its status within India, for example-private airline or government owned; (iii) the general economic conditions for industry and for airlines and (iv) historical record and current state of airline, for instance its safety record, age of aero planes.
Credit enhancement	Growmore Securities will consider if an insurance company, say, Moonlight Insurance should be approached to “wrap” the deal by providing a guarantee of backing for the SPV in the event of default. This insurance is provided in return for a fee.

Sunrays securitization deal structure



Sunrays securitization deal structure-Steps of procedure

- Sunrays Airlines sells its future ticket receivables to an SPV/SPE, set up for the deal, incorporated as Fun Airways
- Fun Airways issues FRNs in order to fund its purchase of receivables
- Fun Airways pledges its right to receivables to a fiduciary agent, the securities trustee, for the benefit of FRN holders
- The trustee accumulates funds as they are received by the SPV
- The FRN holders receive interest and principal payments, in the order of priority of notes, on a quarterly basis

In the event of default, the trustee will act on behalf of the FRN holders to safeguard their interests.

Illustration of a typical securitization transaction and the fee it might generate

• Average expected yield on the pooled loans	14.00%
• Promised fees and payments on securitized loans	
➢ Coupon rate promised to investors who buy the securities against a pool of loans	9.00%
➢ Default rate on pooled loans	4.00%
➢ Fees to compensate a servicing institution for collecting payments from the loans in the pool and for monitoring the performance of the pooled loans	0.25%
➢ Fees paid for advising on how to set up the securitized pool of loans	0.25%
➢ Fees paid for providing a liquidity facility to cover any temporary shortfalls in cash needed to pay security investors	0.25%
➢ Residual income for securitizing institution (leftover after payment of all fees and payment of the coupon rate promised to investors)	0.25%
• Sum of all fees, promised payments, and residual interest income	14.00%

Case of Bond Issue under Debt Resolution Arrangement by an Asset Reconstruction Company

Asset Reconstruction Company: Reliable ARC Ltd

A Company whose debts are reconstructed under the resolution plan : Sunbeam Auto Ltd

Face value of bonds issued : Rs.300 million

The tenor of the bond : 3 years

Issued at a discount of : 60 % of the face value

Discussion issues: (a) Type of bond issued by Reliable ARC and reasons; (b) Yield on bond, (c) Treatment in the balance sheet, Profit and loss account, and cash flow statement.

Case of Bond Issue under Debt Resolution Arrangement by an Asset Reconstruction Company

Face Value		300		180	
Issue price		60%	1	₹ 213.41	₹ 33.41
Issue Value		180	2	₹ 253.03	₹ 39.62
Term	Years	3	3	₹ 300.00	₹ 46.97
					₹ 120.00
Yield		18.5631%			

Barriers commonly encountered during securitization deal

- Minimum size is required
- The loan purchaser usually seeks recourse to the originator
- The loan originator is expected to absorb losses should any borrowers (obligors) in the securitized assets default
- Loan purchasers may set a very high standard in terms of quality of loans making it difficult to satisfy
- Legal and regulatory framework
- Investor awareness

Secondary Market for Securitized Papers in India

- Securitization is largely a capital market window globally.
- In India, the securitized paper is largely privately placed
- The incentives/ motivations to list the papers and reach out to the retail investors at large is currently not there
- Securities Exchange Board of India has set up facilitating guidelines for a listing of securitized debt.
- There is only one ABS that has been listed so far.