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SECURITIZATION-TRANSFORMING ILLIQUID SECURITIES INTO TRADEABLE SECURITIES

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Abstract
In India, a Non-Performing Asset (NPA) is broadly defined as one with interest or principal repayment instalment unpaid for more than 90 days. A lot of time was therefore spent in the judicial process before banks could have any chance of recovery on their loans. To speed up the process of recovery from NPAs, The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) Act was enacted in 2002 for regulation of securitization and reconstruction of financial assets and enforcement of security interest by secured creditors. The SARFAESI Act empowers Banks / Financial Institutions to recover their non-performing assets without the intervention of the Court. The SARFAESI Act has been the most important means for recovery of NPAs.

Keywords:Npa, Sarfaesi, Arc, Drt, Drat.

Introduction

Banks and other financial institutions (FIs) faced various problems in recovering the defaulted loans and advances due to the usual delay by our courts in disposal of recovery proceedings. Therefore, the Government enacted the Recovery of Debts due to Banks & Financial Institutions (RDBF) Act in 1993 and the SARFAESI Act in 2002 (Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests Act) to expedite recovery of these non-performing assets (NPAs) of the banks and Financial Institutions.

Securitization has been one of the villains of the global financial crisis, with lenders selling housing loans to subprime borrowers and then packaging these loans into marketable securities that have been sold to investors around the world. Securitization originated in the mortgage markets in the US. It was promoted with the active support of the government, which wanted to promote secondary markets in mortgages to allow more liquidity for mortgage finance companies. At that time, housing in the US was funded by the thrift industry, which attracted deposits to provide loans to housing borrowers. The demand from the housing borrowers was so huge that the thrift industry did not have adequate funds to lend. At that time, the major issue was not the cost of funds, but their availability. Wall Street attempted to address the impending demand for funds by coming up with an alternative source of funds. The idea was to create an adjunct to the thrift industry, but not to replace it.

The SARFAESI Act, 2002 aims to regulate securitization and reconstruction of financial assets and enforcement of security interest and to provide for a Central database of security interests created on property rights and for connected matters therewith. The Act has simplified the recovery procedure for banks and specified financial institutions for recovery of secured debts from borrowers without intervention of Courts at the first stage. Borrowers can file applications in the Debts Recovery Tribunals (DRTs) against action taken for enforcement of security interest under this Act, with the appellate jurisdiction for such applications lying with the Debts Recovery Appellate Tribunals (DRATs). The Act is applicable to cases where security interest for securing repayment of any financial asset is more than Rs.1 lakh and the amount due is 20% or more of the principal amount and interest

thereon. The Act is not applicable to any security interest created in agricultural land and certain properties not liable to attachment under some specified Acts.

The objectives of the SARFAESI Act are:

- Specifies the legal framework identified with the scanning activities in India.
- Mentions the procedures for Non – performing assets transfer to the asset reconstruction companies for their reconstruction purpose. This allows fast and effective recovery of NPAs with respect to banks and FIs.
- Allows financial institutions and banks to sell properties (business or residential), in case the borrower fails to reimburse their loans.
- Confers powers to the financial institutions to take custody of the immovable property that is hypothecated or charged for debt recovery.
- Imposes the security interest with no interspecific legal framework identified with the scanning activities in India.

Objectives & Research Methodology

The purpose of the study is to understand that the SARFAESI Act helps in transforming the illiquid assets into tradeable securities. The study mainly is based on secondary sources of information as available from various articles published in journals. The secondary data for this paper includes the literature published by Indian public and private sector Banks, Reserve Bank of India, various finance magazines, Journals, RBI database warehouse and other research papers.

Securitization And Reconstruction of Financial Assets And Enforcement Of Security Interests Act, 2002

The financial sector has been one of the key drivers in India's efforts to achieve success in rapidly developing its economy. While the banking industry in India is progressively complying with the international prudential norms and accounting practices, there are certain areas in which the banking and financial sector do not have a level playing field as compared to other participants in the financial markets in the world. There is no legal provision for facilitating securitisation of financial assets of banks and financial institutions. Further, unlike international banks, the banks and financial institutions in India do not have power to take possession of securities and sell them. Our existing legal framework relating to commercial transactions has not kept pace with the changing commercial practices and financial sector reforms. This has resulted in slow pace of recovery of defaulting loans and mounting levels of non-performing assets of banks and financial institutions. Narasimham Committee I and II and Andhyarujina Committee constituted by the Central Government for the purpose of examining banking sector reforms have considered the need for changes in the level system in respect of these areas. These Committees, inter alia, have suggested enactment of a new legislation for securitisation and empowering banks and financial institutions to take possession of the securities and sell them without the intervention of the court.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002 was promulgated on the 21st June, 2002 to regulate securitisation and reconstruction of financial assets and enforcement of security interest and for matters connected therewith or incidental thereto. The provisions of the Ordinance of liquidity, asset liability mismatches and improvement in recovery by exercising powers to take possession of securities, sell them and reduce non-performing assets by adopting measures for recovery or reconstruction."

Through the SARFAESI Act, secured creditors (banks or financial institutions) have many rights for enforcement of security interest under section 13 of this act. If the borrower of financial assistance makes any default in repayment of a loan or any instalment and his account is classified as Non-performing Asset by secured creditor, then secured creditor may require before expiry of period of limitation by written notice to the borrower for repayment of due in full within 60 days by clearly stating amount due and intention for enforcement.

Basically, the SARFAESI Act empowers financial institutions to 'seize and desist'. They should give a notice to the defaulting borrower asking to repay the amount within 60 days. If the debtor doesn't comply, the bank can resort to one of the three following measures:

- Take the possession of the loan security.
- Sell or lease or assign the right over the security.
- Manage the asset or appoint someone to manage the same.

The Act also provides for the establishment of Asset Reconstruction Companies (ARCs) to acquire assets from banks and other financial institutions. ARCs are regulated by the RBI. The SARFAESI Act, 2002 gives detailed provisions for the formation and activities of Asset Securitization Companies. Scope of their activities, capital requirements, funding, etc. are given by the Act. RBI is the regulator for these institutions.

As a legal mechanism to insulate assets, the Act addresses the interests of secured creditors (like banks). Several provisions of the Act give directives and powers to various institutions to manage the NPAs. The Act facilitates the reconstruction of financial assets which are acquired while exercising powers of enforcement of securities or change of management or other powers which are proposed to be conferred on the banks and financial institutions.

Debts Recovery Tribunals (DRT) and Debts Recovery Appellate Tribunals (DRAT) have been constituted for establishment of Tribunals for expeditious adjudication and recovery of debts due to Banks and Financial Institutions and for matters connected therewith.

Original Applications to be filed by Banks and Financial Institutions before Debt Recovery Tribunal for recovery of dues not less than Rs.10 lakhs, under Recovery of Bank Due to Banks & Financial Institutions Act, 1993.

Bank can simultaneously initiate proceedings under SARFAESI Act, 2002 as well. Any person aggrieved on account of order passed by DRT may file an appeal before DRAT.

Features of the Sarfaesi Act, 2002

1. Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 aims to protect banks and financial institutions from incurring losses. Its features are:
2. Enforcement of security interests: The Act enforces security interests by the secured creditors with no involvement of the court. In case of a default by a borrower, the act authorizes the bank or a financial institution to issue a demand notice to the borrower and induces him/her to satisfy off the obligations within sixty days from the date of the notification.
3. Reconstruction of financial assets: SARFAESI Act allows the banker and financial institutions to take legitimate measures of the management, sale, settlements, debt restriction, or take any possession under SBI guidelines every now and then.

4. Securitization of financial assets and issue security receipts: The primary point of the securitization act is to make accessible the enforcement of security interest for example to take possessions of the assets that were given security for the loan.
5. Act as an agent of banks or financial institutions: The SARFAESI Act 2002 acts as the manager of the secured assets given by the financial institutions and ensures that the dues are recovered at an ideal time.

Methods of Recovery

Securitization is the process of converting existing assets or future cash flows into marketable securities. In other words, securitization deals with the conversion of assets, which are not marketable, into marketable assets. Some assets that can be securitized are existing loans, such as car loans, housing loans, etc. Over a period, securitization has extended to the future cash flows too. Securitization is possible with the conversion of existing assets as well as future cash flows. Securitization is broadly divided into two categories:

1. Asset-backed securitization
   Asset backed Securities are the most general class of securitization transactions. The asset in question could vary from Auto Loan/Lease/Hire Purchase, Credit Card, Consumer Loan, student loan, healthcare receivables and ticket receivables to even future asset receivables. Securitization enables the issuer to raise funds more cheaply than would be possible on the strength of the originator's balance sheet alone. Securitization of assets can add liquidity, lower risk, and improve economic efficiency.
2. Future cash-flows-backed securitization
   Another way is to securitize future cash flows, such as ticket sales, credit card payments, car rentals or any other form of future receivables. Securitization is the process of transforming an illiquid asset or group of assets into tradable securities through financial engineering. Securitization constitutes a key segment of structured finance. It is a technique by which identified receivables can be packaged into transferable securities and sold to investors. The instruments issued under a securitization deal derive their value from the cash flows, current or future, or by any collateral security. Normally, these instruments do not have any recourse to the originator other than the aforementioned assets. The central idea of securitization involves the pooling of like assets and then repackaging the underlying cash flows to make them more attractive to investors.

As securitization is the process of converting illiquid loans into marketable securities. The lender sells his or her right to receive future payments from the borrowers to a third party, and is paid for it. The lender is therefore repaid at the time of securitization. These future cash flows from the borrowers are sold to investors in the form of marketable securities.

Source: CRISIL.

Importance of Securitization

Securitization transforms illiquid assets into tradable financial securities. When loans are converted into financial securities, they become tradable and, therefore, more liquid than the underlying loans or receivables. Securitization of assets can lower risk, add liquidity and improve economic efficiency. After securitization, risk is reduced, if not eliminated, as the securities issued do not represent a Single asset but a pool of assets. In securitization, crores of illiquid assets disappear from the balance sheet overnight to become liquid assets. After securitization, assets in the form of loans disappear from the originator's balance sheet and its liquidity improves. Sometimes, assets are worth more off the balance sheet than on it. This is exactly what securitization does. Wal-Mart wants to sell its inventory as quickly as possible as it earns a small margin on each item sold, and the more times inventory is turned over (sold), the more profit Wall-Mart makes. Similarly, financial service firms also want to sell their inventory of loans several times-via the process of securitization-to improve their returns. A group of consumers loans can be transformed into debt securities which can be traded. As they become tradable, they become more liquid.

Indian Securitization Market

Securitization has emerged globally as an important technique for bundling assets and segregating risks into marketable securities. In line with global trends, the landscape of securitization in India too has changed dramatically in the last decade. No longer is securitization wed to traditional assets, such as mortgages, bank loans, or consumer loans (called self-liquidating assets). The Indian securitization industry has potential to remain an attractive source of capital for the Indian financial industry. In India, Citibank pioneered securitization in 1991. Though securitization of auto loans remained the mainstay throughout the 1990s, over time, the market has spread into several asset classes-housing loans, corporate loans, commercial mortgage receivables, project receivables, toll revenues, and recently, microfinance loans have also been securitized. Within the auto loan segment, the car loan segment has been more successful than the commercial vehicle loan segment due to the perceived lower credit risk, higher volumes and the homogenous nature of receivables. Other types of receivables for which securitization has been attempted in the past includes property rental receivables, power receivables, telecom receivables, lease receivables and medical equipment loan receivables. The securitized debt market in India is estimated to be around R40,000 crore. Securitization is the future of India in the place of traditional lending by banks. The potential market in India for the securitization business is estimated at over a trillion rupees. As of 30 June 2011, the total securitization in USA is 5 trillion dollars, a staggering 25 per cent of all debt outstanding. For India, this figure is a paltry 1.6 per cent, with less than 100 billion of outstanding securitized debt.

Conclusion

Securitization is the process of transforming illiquid assets (assets which are difficult to be realized) into marketable securities. First, a financial institution identifies and bundles homogeneous loans or other income-producing asserts and sells them to an intermediary. Second, the intermediary aggregates similar loans and mortgages to issue tradable and interest-bearing securities to raise funds in the capital market. The intermediary collects the funds from the sale of securities and pays the financial institutions. The process involves the aggregation of similar instruments, such as loans and mortgages, in terms of risk, to enable the issuance of negotiable and tradable securities. The fundamental principle in securitization is identification of risks and allocation of the securities to those parties who are willing to assume the risks for the returns they carry It involves the creation and issuance of debt securities or bonds, where the payments of principal and interest derive from cash flows from the pool of assets,

backing them. Deposits are the main source of funds for a bank to lend. Therefore, the size of a loan portfolio is related to the quantum of deposits it can mobilize. In case of a mismatch between aggregate deposits and loans, banks meet the shortfall from marketable borrowings. However, marketable borrowings cannot be used for long-term lending. In such a situation, securitization is the answer to this question. Securitization enables the pooling of assets and their sale to an intermediary, who issues securities, representing interests in the pool of assets. In a way, through securitization, illiquid assets are transformed into tradable financial securities. Banks can sell their existing debt portfolio to raise funds to lend further, using the proceeds of securitization

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