ASSET SECURITISATION: UNUTILIZED OPPORTUNITY IN SRI LANKA

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Nobel laureate Dr. A. Michael Spence wrote: "Financial innovation, intended to redistribute and reduce risk, appears mainly to have hidden it from view. An important challenge going forward is to better understand these dynamics as the analytical underpinning of an early warning system with respect to financial instability."

The objective of this article is to discuss the importance of Securitisation and how it could be used for managing business risk. The very subject of securitisation was embedded with such complexity, no one, not even it's creators fully understood the diffusion of risk, let alone the simultaneous concentration of systemic risk. However, asset securitisation enables banks & other financial institutions to allocate capital more efficiently, access diverse and cost effective funding sources, and better manage business risks by using the securities/capital markets to fund fractions of the loan portfolio. Indeed, the successes of non-banking securitisers are forcing banks to adopt some of their practices. Further, the growing competition within the banking industry from specialised firms that rely on securitisation puts pressure on traditional banks to use securitisation to streamline their credit and originations business as much as possible. Securitisation has a fundamental impact on banks and the financial services industry; therefore, it becomes necessary for bankers to have a clear understanding of it's benefits and inherent risks.

The traditional mortgage model involved a bank/financial institution originating a loan to the borrower/homeowner and retaining the credit (default) risk. However, with the advent of securitisation, the traditional model has given way to the "originate to distribute" model, in which banks essentially sell the mortgages and distribute credit risk to investors through mortgage-backed securities. Securitisation meant that those issuing mortgages were no longer required to hold them to maturity. By selling the mortgages to investors, the originating banks replenished their funds, enabling them to issue more loans and generating transaction fees.

History of Securitisation

The history of securitisation depends upon, "what the meaning of securitisation is, that we adopt?". One could take broad meaning as to include securitised loans or every securitised instrument, in which case securitisation goes as deep in history as the very concept of a body corporate. However, in the sense in which it is understood presently viz as a tool of structured finance, securitisation was developed in US real estate market, and from there, it spreaded not all over the world but to diverse applications.

However, in Europe, a form of mortgage funding has existed for a long number of years which has remarkable similarities to the present form of securitisation though they are not the same. This instrument has existed in Denmark for more than 200 years, much longer than the US mortgage backed securities. The history of the US government efforts to introduce a secondary market in mortgage goes, back to the 1930s and in 1938, the Federal National Mortgage Association was created to buy and sell federally- insured mortgages. In 1970 Ginnie Mae did it's first securitisation transaction on a "pass through" structure and securitisation gained popularity all over the world over the last four decades. The securitisation is resilient through recessions and was noticed in 1991 and has proved beyond the doubt in 2001.

It is well known that the financial turmoil of 2007-2008 had it's roots in the sub-prime mortgage crisis in the United States. There are several causes which triggered the sub-prime mortgage crisis; among them, the lax lending policies and the securitisation practices played a prominent role. The securitisation of assets, especially, mortgage loans, is a form a financial innovation which gained popularity in the United States, beginning from the 1970s. This technique permits that homogenous packages of bank loans to be changed into securities and then sold to the final investors in the capital market. By securitisation of loans, banks may transfer the credit risk to the final investors and, therefore, they have no incentive to make a strict assessment of the risk of insolvency. In this context, it seems that securitisation of the sub-prime mortgages contributed to the deterioration of credit granting process, with dramatic consequences on the value of the mortgage-backed securities. Subsequently, such tension spreaded to other international financial markets, to the entire market in asset-backed securities and other parts of the credit market. A more direct connection between securitisation and the subprime crisis relates to a fundamental fault in the way that underwriters, rating agencies and investors modeled the correlation of risks among loans in securitisation pools. In this context it is important to discuss the structure of typical asset securitisation and securitisation market in Sri Lanka.

What is Asset securitisation?

Securitisation can be defined as a financing tool. It involves creating, combining and recombining categories of assets and securities into new forms. Assets, loans, receivables, etc, from multiple sellers or obligors are pooled and repackaged, underwritten and sold in the form of asset-backed or other securities. Securitisations provide financing for the sellers of the assets. These 'asset-backed securities' (ABS) are collateralised or 'backed' by the pooled assets. While securitisation structures can vary significantly, in general the investor in an ABS is entitled to receive a pass through the timely payment of interest and principal on the pooled assets. The investor, therefore looks to the cash flow from the purchased assets for repayment. A typical securitisation involves the creation of a Special Purpose Vehicle (SPV) that issues multiple classes of equity and debt securities consisting of one or more tranches of investment grade debt and one or more tranches of non-investment grade debt and/or equity. The risks associated with the underlying asset pool are allocated among the various tranches utilising various forms of credit

enhancement.

Securities issued by the SPV in a securitisation transaction are referred to as Asset Backed Securities as the 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 (originator), or the entity issuing the securities (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 mortgaged housing loans. All securitised instruments are either MBS or ABS.

Why asset securitisation is needed?

The securitisation process allows banks and financial institutions to separate financial assets from credit, performance and other risks associated with the banks themselves. As a result, the amount of capital required to finance the pooled assets may be proportionally less than that for the bank as a whole. The reason being - the bank's overall capital costs must take into account all of the collective risks and uncertainties associated with its operations. In addition, securitisations convert illiquid loans or assets that cannot be easily sold to third party investors into liquid, marketable securities. Thus, securitisations allow the movement of investments from less efficient debt markets to more efficient capital markets, resulting in lower funding costs.

Different forms of securitisation

I. **Fully amortising structures** - Designed to closely track the repayment of the underlying loans that amortise through scheduled principal and interest payments. In fully amortisedon structure, principal is returned to investors throughout the lifecycle of securitisation. As a result, this structure may face greater prepayment risk if the underlying loans are prepaid sooner than expected. This is called full amortization securitisation.

II. **Revolving debt (credit card or trade receivables)** - Works well with controlled or revolving amortisation structures. During a revolving period, only interest payments are made. Proceeds from repayments of the underlying receivables are used to purchase additional receivables. This structure is intended to provide investors with a relatively predictable payment stream. Once the revolving period has ended, investors receive defined periodic principal payments. In a variation of this structure, principal is returned to investors after the revolving period in a single payment. This is called controlled or revolving amortisation.

III. **Floaters** - Under this structure securities are sold on floating interest rates which are adjusted periodically. The structure can be used for both amortising assets and revolving

assets. Usually, floaters include interest rate swaps to protect investors against disparities in the interest rates for the ABS and the underlying assets.

IV. **Sequential Pay** - A sequential pay securitisation creates multiple tranches of securities with different maturity periods. Normally, the shortest average life tranche receives 100 percent of principal payments until the tranche is repaid in full. Then the next tranche is paid, and so on. In variations of this structure, at some point over the life of the securitisation, payments shift from sequential to prorate or from pro-rata to sequential upon the occurrence of certain credit events.

V. **Collateralised Debt Obligation CDOs** - A Collateralised Debt Obligation (CDO) is a type of securitisation consisting of a pool of bonds or loans. The underlying pool of bonds or loans are often actively managed and traded by professional collateral managers. CDOs can be broadly classified into two categories, namely, cash flow and market value. In cash flow CDOs, the ratings of the various tranches of offered securities are based on the underlying pool's ability to generate sufficient cash flows to pay interest and principal on the issued securities. In contrast, market value CDOs are rated on the market value of the underlying pool of bonds or loans and are marked to market on a regular basis to ensure sufficient collateral to pay interest and principal.

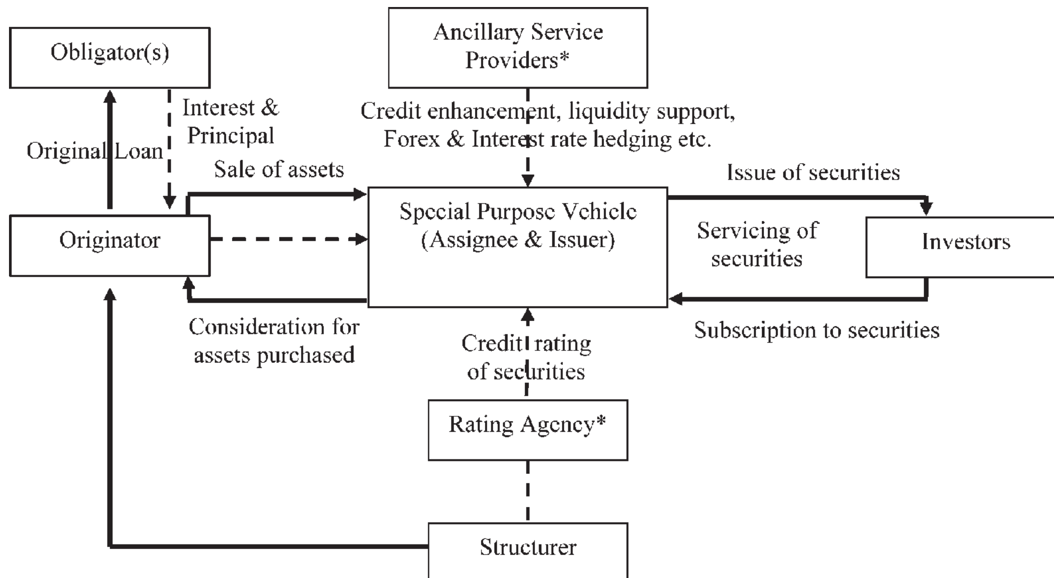
VI. A**sset-backed commercial paper/multi-seller commercial paper conduits** - Asset-backed commercial paper (ABCP) programmes can be used to finance the assets of one or more sellers and can either be single or multi-seller conduits. ABCP programmes issue short term commercial paper, but may nevertheless hold assets with much longer maturities. As a result, credit enhancement and liquidity facilities play important roles in ABCP programmes. The credit enhancement facility (which can be in the form of a loan commitment, collateral account, letter of credit, derivative or other similar facility) will provide either full or partial coverage of credit, liquidity, interest rate and legal risks present in the conduit. Partial protection functions at two levels: loss at the asset level and loss on a programme wide basis on any asset pool. Liquidity facilities in the form of a liquidity loan agreement or liquidity asset purchase agreement are used to protect investors from timing differences in cash flows. Liquidity facilities also cover commercial paper rollover risk.

Securitisation structures

An optimum securitisation structure to a large extent depends on the nature of the assets being securitised, principally the timing and consistency of the cash flow.

The SPV, in turn, issues multiple classes or tranches of securities representing the right to receive fractions of the payment streams arising from the pooled assets. The return on different tranches can vary significantly and can be enhanced through different forms of credit enhancement. Tranches that enjoy greater priority of payment get higher ratings and benefit from credit enhancement.

Typical Securitisation transaction model



* Rating of the securitisation issues and services of ancillary service providers not taking place in the Sri Lankan securitisation market may be due to the fact that all these issues are private placements. However, both investors and arrangers consider the credit rating of the originator as risk mitigating measure when doing asset securitisation transactions.

A securitisation transaction generally involves some or all of the following parties:

- The primary owner of the asset (the originator or sponsor) who has a loan agreement with the borrowers (obligors);
- The issuer of debt instruments is also the SPV. The structure keeps the SPV away from bankruptcy of the originator, called 'bankruptcy remote';
- The investment bankers who assist in structuring the transaction who underwrites or places the securities for a fee;
- The rating agencies, who assess credit quality of certain types of instruments assign a credit rating;
- The credit enhancer, possibly a bank, guarantor, or insurer, who provides credit support through a letter of credit, guarantee, or other assurance;
- 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;
- The trustee, who deals with issuer, credit enhancer and servicer on behalf of the security holders;
- The legal counsel, who participates in the structuring of the transaction &
- The swap counterparty that provides interest rate/currency swap, if required.

Parties to a securitisation transaction

Parties to a securitisation deal have different roles to play. The entire process is broken up into separate roles such as origination of loans, raising funds from the capital markets, servicing of loans etc. This kind of segmentation of market roles introduces several efficiencies to the process of asset securitisation.

Principally, there are three parties in a securitisation transaction. They are originator, SPV & investors:

Originator	SPV	Investors
Originator is the owner of the assets to be securitised. He is the primary mover of the deal i.e. sets up the necessary structures to execute the deal. The originator sells the assets 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.	The issuer also known as the SPV buys the assets (to be securitised) from the originator. The SPV is primarily a low-capitalised entity with defined purposes and activities, governed by independent trustees. The SPV plays a very important role by holding these assets in its books and makes upfront payment for them to the originator.	Investors may be individuals or institutional investors like financial institutions, 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 an agreed pattern.

Other parties to the transaction

The obligor(s)- is the borrower of the original loan from the originator. The amount outstanding from the obligor is the asset that is transferred to the SPV. In a securitisation transaction the credit standing of the obligor(s) is of prime importance.

The rating agency - an external credit rating plays an important role since it is the investors who take on the risk of the asset pool rather than the originator. The rating process assesses the strength of the cash flow and the mechanism designed to ensure full and timely payment.

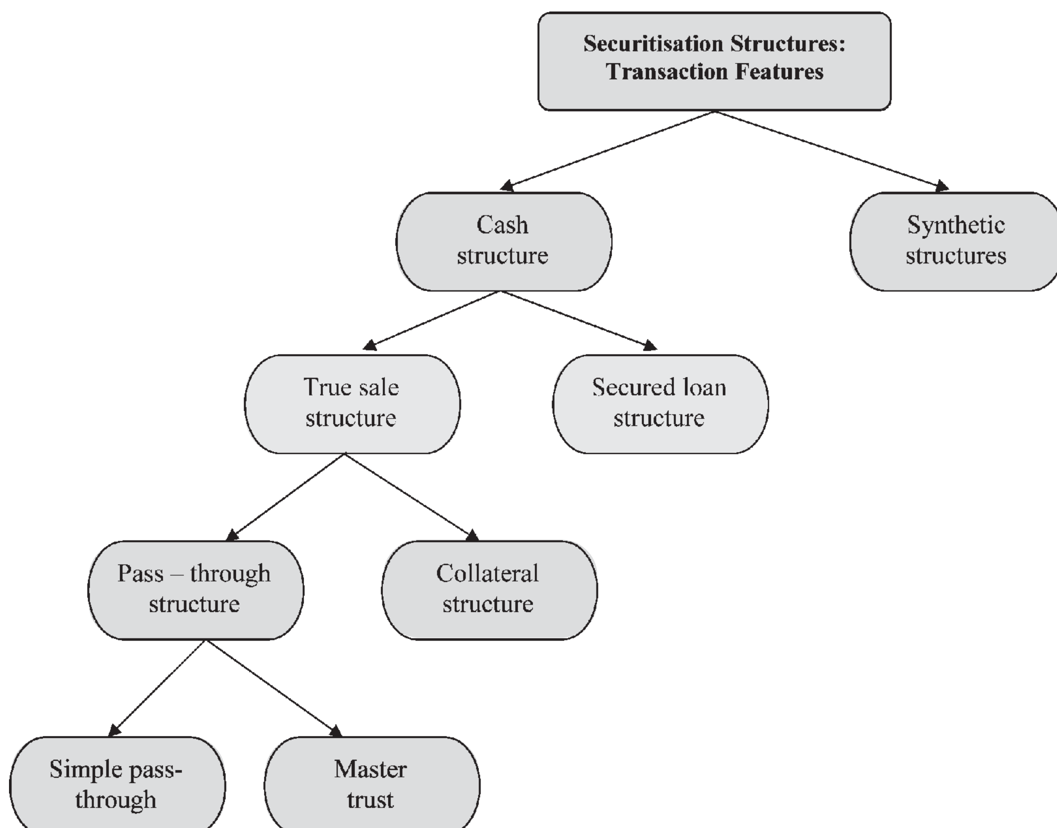
Administrator or servicer - collects the payment due from the obligor(s) and passes it on to the SPV. Further, it follows up with delinquent borrowers and takes up legal options available against the defaulting borrowers. It is also termed as the 'Receiving and Paying Agent' as it receives the installments and pays it to the SPV.

Auditor (due diligence audit): the objective of the a due diligence audit is to ensure that all transactions being securitised are legally valid, all transactions comply with the pool selection criteria, all transactions comply with the underwriting standards agreed upon, securities there under have been colleted, there are no limitations against assignments, there are no legal suits or counterclaims pending, etc. The audit would also help to track the payment history of the selected receivables. The due diligence process may undertake either case by case examination, or a sample test depending upon the nature of the portfolio.

Agent and trustee - is responsible for monitoring whether all parties to the securitisation deal perform in accordance with the securitisation trust agreement. The agent safeguards the interests of the investors.

Structurer - generally, an investment banker is appointed as a structurer to facilitate the structuring of securitisation deals by bringing together the originator, credit enhancer(s), the investors and other partners.

Types of Securitisation Transaction Structures



Cash vs synthetic structures

In a synthetic transaction, the seller does not sell assets for cash i.e., keeps his title and investment on the assets unaffected. The seller merely transfers risks/rewards relating to the asset by entering into a derivative transaction. When securities are issued by the SPV, they carry such embedded derivative. Most securitisations follow the traditional cash structure globally under which the originator sells assets and gets cash. Synthetic securitisations are more popular in Europe and Asia.

True sale vs secured loan structures

Securitisation transactions are usually framed as the sale of the underlying asset by the originator or holder of the asset i.e., true sale. On the contrary, in a secured loan structure, the originator or the holder of the assets takes a loan similar to any secured lending. The investor rights, in this case, are kept safe by creating a fixed and a floating charge. The assets to be securitised are generic assets of the originator and do not belong to a specific asset pool as in the case of a true sale. The secured loan structure is more popular in UK.

Pass through vs collateral structure

In a pass through structure, the investors are made to proportionally participate in the cash flow emanating out of specific assets of the originator. The SPV is simply a distribution device. Pass through structure is the most basic and simplest way of securitisation in mortgage markets. In a collateral structure, the SPV buys the assets of the originator in the same way as in a pass through structure but instead of distributing the cash flow among the investors, it issues debt that is collateralised by the assets that are transferred by the originator. This can also be referred to as the pay through structure. It is popularly known as Collateralised Mortgage Obligation (CMO) as well.

Discreet trust vs master trust

Discreet trust implies one SPV for one pool i.e., investors participate in the cash flow of an identified pool. Creation of a master trust by the originator or the holder of the assets involves transfer of a substantial amount of receivables, larger than the funding received from investors. Several security issuances can be created from this fund or master trust either concurrently or consecutively. Master trust serves as a tool to create disparities between the repayment structures and the tenure of the securities and assets in the pool. Master trusts are increasingly becoming the preferred mode of securitsation as a result of their flexibility.

Pass and pay through structures (PTC)

The nature of the investors' interest in the underlying assets determines whether a securitisation structure is a 'pass through' or a 'pay through' structure. In a pass through structure, the SPV issues 'pass through certificates' which are in the form of participation certificates and

enable the investors to take a direct exposure on the performance of the securitised assets. Pay through, on the contrary, 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. Pay through structures permit desynchronisation of servicing of the securities from the underlying cash flows. In the pay through structure, the SPV is given discretion (though to a limited extent) to reinvest short-term surpluses. This option, however, 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 secured to the extent of credit enhancement. Prepayments are, however, passed on to the investors who then have to tackle reinvestment risk. A further advantage of the pay through structure is that different issues of securities can be ranked, and priced differentilly.

Credit enhancement

Credit enhancement refers to any means that attempt to buffer investors against losses on the assets collateralising their investment. These losses depend on the asset characteristics, origination and administration, thus may vary in frequency, severity and timing. Credit enhancements are often essential to secure a high level of credit rating 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 described below:

How does a third party involved in a securitisation transaction?

Third-party letter of credit : Third party may provide a letter of credit to cover the loss or percentage of losses for issuers with credit ratings below the level sought for the security issued. Withdrawals on the letter of credit are often repaid from excess cash flows from the securitised portfolio.

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.

Insurance : Guarantees are issued by third parties, usually AAA-rated monocline insurance companies. Providers generally guarantee (or wrap) the principal and interest payments of 100 percent of a transaction.

Internal measures taking place in a securitisation transaction

Credit Tranching (senior/subordinate structure): The SPV issues two (or more) tranches of securities and establishes a predetermined priority in their servicing. 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, which are 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. Since cash is 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 the yield to the investors from the securities is excess spread. 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 preset levels of collateral performance are breached, all further collections are applied to repay the funding. Once amortisation is triggered, substitution stops and the early repayment becomes an irreversible process. Triggered amortisation is typically applied in future flow securitisation.

Structured finance and securitisation

The term 'structured finance' refers, very broadly, to financial solutions or products, which are structured to meet specific needs. In a narrow and more common sense, the word is used almost interchangeably with securitisation. One of the crucial features of securitisation is the creation of different classes of securities, so that they are assigned different ratings. The senior most of the securities is quite often rated AAA.

The highest rating for the senior most class is explained by two factors: isolation of the assets from the bankruptcy risks of the originator, (originator independence) and the creation of a credit risk mitigation device by subordination of classes B and C, so that those lower classes provide credit support to class A. It is possible to say that the size of classes B and C was so computed to meet the rating objective for class A. Likewise, the size of class C was so computed to have class B accorded the desired rating. In other words, the entire transaction was engineered, or structured, to meet specific investor needs. Investors have different risk return profiles, based on their liability structures, and the objectives of their respective investors or stakeholders. Hence, there might be a yield hungry investor looking for a BBB rated security, but with a substantially higher spread. Thus, the use of structured finance principles allows the originator company to create securities that meet investor needs. Rating is not the only basis for structuring of securities. There are several other features with respect to which securities may differ. Interest sensitivity (i.e., duration and convexity), maturity or average life, cash flow pattern, and prepayment are just a few examples of such features.

Benefits of asset securitisation

For originators - By converting an on-balance-sheet lending business into an off-balance-sheet fee income stream, which is less capital intensive, securitisation improves returns on capital. Securitisation is also instrumental in lowering borrowing costs, releasing additional capital for expansion or reinvestment purposes, and improving asset/liability and credit risk management, depending on the structure used.

For investors - Securitised assets offer a combination of attractive yields, secondary market liquidity and more protection through collateral overages and/or guarantees by entities with high and stable credit ratings. Since their payment streams can be structured to meet investors' particular requirements, securitised assets also offer a measure of flexibility. Due to structured credit enhancements and diversified asset pools, the investors need not have a thorough understanding of the underlying loans. This has been probably the single largest factor, which has facilitated the growth of the structured finance market.

For borrowers - Securitisation makes borrowing costs lower for both individuals and corporations. Financial institutions can re-deploy funds available from realisation of previous loans. As a result, new funds can be raised from the capital markets and savings can be passed on to the borrowers in terms of reduced borrowing costs. Securitisation also reduces financing costs for corporations. MBS and ABS normally have high credit ratings which make them less risky and lowers interest rates for the originating firm. Thus the savings are passed on to the customer as lower lending rates. Securitisation facilitates geographic dispersion of capital to regions where credit options are scarce. Traditionally, local financial institutions provide credit in the areas they operate in. However, through securitisation of loans (linking returns to capital markets), the lending institution can infuse more capital for new loans for borrowers in locations other than it's own.

Disadvantages to issuer

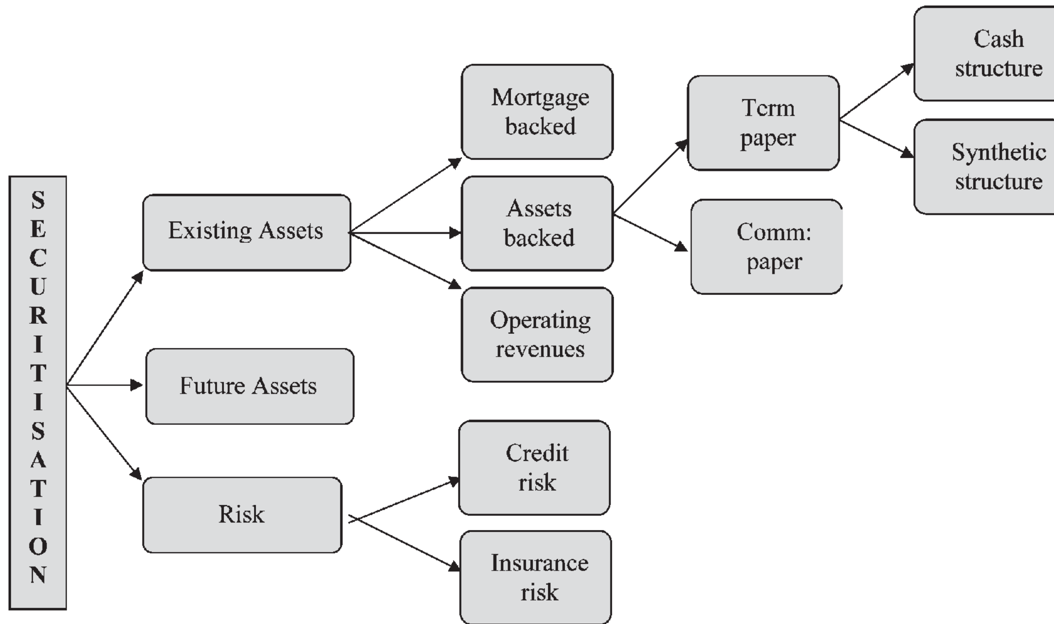
May reduce portfolio quality: If the AAA risks, for example, are being securitised out, same would leave a materially worse quality of residual risk.

Costs : Securitisations are expensive due to management and system costs, legal fees, underwriting fees, rating fees and ongoing administration. An allowance for unforeseen costs is usually essential in securitisations, especially if it is an atypical securitisation.

Size limitations : Securitisations often require large scale structuring, thus may not be cost-efficient for small and medium transactions.

Risks : Since securitisation is a structured transaction, it may include par structures as well as credit enhancements that are subject to risks of impairment, such as prepayment, credit loss, especially for structures where there are some retained strips.

Various Securitisation Structures



Risks Involved in Securitisation

Liquidity risk : Credit/default risk is generally accepted as a borrower's inability to meet interest payment obligations on time. For ABS, default may occur when maintenance obligations on the underlying collateral are not sufficiently met as detailed in it's prospectus. A key indicator of a particular security's default risk is it's credit rating. The level of credit risk is a function of the quality of the portfolio and credit enhancements. However, a hard look at the credit quality is one of the most important things for an investor, as the investor has invested his money on the strength of the assets and not the quality of the originator. But the way securitisation is practiced in Sri Lanka, investor needs to look at both strength of the assests as well as the quality of the originator.

However, the credit crisis of 2007-2008 has exposed a potential flow in the securitisation process loan originators retain no residual risk for the loans they make, but collect substantial fees on loan issuance and securitisation, which doesn't encourage improvement of underwriting standards.

Event risk : Prepayment/reinvestment/early amortization: The majority of revolving ABS are subject to some degree of early amortization risk. The risk stems from specific early amortization events or payout events that cause the security to be paid off prematurely. Typically, payout events include insufficient payments from the underlying borrowers, insufficient excess Fixed

Income Sectors: Asset-Backed Securities spread, a rise in the default rate on the underlying loans above a specified level, a decrease in credit enhancements below a specific level, and bankruptcy on the part of the sponsor or servicer.

Transaction legal risk: This represents the possibility that some of the fundamental legal assumptions in the transaction are proved invalid. For example a court may disregard SPV's title over the receivables recharacterising the whole transaction as a financial transaction. Even if the SPV's rights over the receivable are honoured, the actual safety of the collateral could still be open to question due to minor technical issues.

Tax risk: Tax uncertainties may sometimes affect the investors. If the SPV is liable to entity level taxes and the payments to investors are treated as payment to equity holders, the entire cash flows in the transaction may be subject to unprecedented taxes. Sometimes underlying cash flows may subject to a withholding tax requirement.

Currency & interest rate fluctuations : Like all fixed income securities, the prices of fixed rate ABS move in response to changes in interest rates. Fluctuations in interest rates affect floating rate ABS prices less than fixed rate securities, as the index against which the ABS rate adjusts will reflect interest rate changes in the economy. Furthermore, interest rate changes may affect the prepayment rates on underlying loans that back some types of ABS, which can affect yields. Home equity loans tend to be the most sensitive to changes in interest rates, while auto loans, student loans, and credit cards are generally less sensitive to interest rates. These are risks that concern the investors, then they need to study them carefully.

Although securitisation can have the advantages of enabling lending to take place beyond the constraints of the banking system, the process could lead to a decline in the total capital employed in the banking system, thereby increasing the financial fragility of the financial system as a whole, both nationally and internationally. With a substantial capital base, credit losses can be absorbed by the banking system. However smaller that capital is, more the losses must be shared by others. This concept especially applies to the countries where banks have traditionally been the dominant financial intermediaries.

Sub-prime Crisis and Securitisation

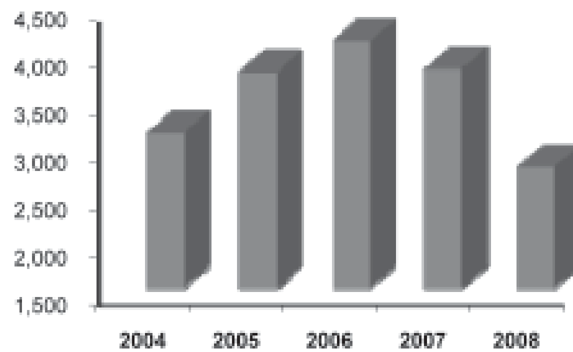
The fallout from high default rates related to US sub prime market has been the root of the global crisis in the securitisation market. In US many sub prime mortgage loans were packaged and sold to investors through Mortgage Backed Securities (MBS). These securities were given a overly high credit rating by the credit rating agencies and contagion was spread further because MBS were sold on to investors through collateralised debt obligations and structured investments vehicles. Some investors, particularly a number of banks acquired vast quantities of these assets which became toxic.

The global market for securitisation has slumped since September 2007, due to turbulence

in credit markets, lack of liquidity and a reduction in investors' tolerance of risk. These difficulties were triggered by sub-prime crisis and compounded by the down fall of Lehman Brothers as well as the nationalization of US federal agencies- Fannie Mae and Freddie Mac.

Global securitisation issuance showed a drop from $ 3,817bn in 2007 to $ 2,777bn in 2008 and net issuance sold to market and purchased by end investors slumped by 79% from $2,138bn to $ 441bn. Estimates for first quarter 2009 point to issuance remaining at a very low ebb. The following graph depicts the value of total gross securitisation issuance in the world during last five years.

Value of Securitization Issuance



Source: IFSL Research, Securitisation 2009

Restoring the Confidence in Securitisation Markets.

The leading industry groups in the securitisation industry have come together in a joint initiative launched in December 2008 that recognizes problems and offers recommendations with a view to restoring the confidence in the securitisation market. Participating organizations include the Securities Industry and Financial Market Association (SIFMA), the American Securitisation Forum, (ASF), the European Securitisation Forum (ESF), and the Australian Securitisation Forum (Aus SF).

The study noted that without an efficient and smoothly functioning securitisation market, banks could fail to meet some $ 2 trillion of demand for credit world wide over the next three years. The initiative recognizes the multiple factors that have contributed to the crisis including deterioration in loan underwriting standards, over reliance on credit rating, growth of complexed highly leveraged positions, misjudgment of liquidity risk, lack of sense of shared responsibility and rising losses in the US sub prime markets which triggered the global crisis in confidence.

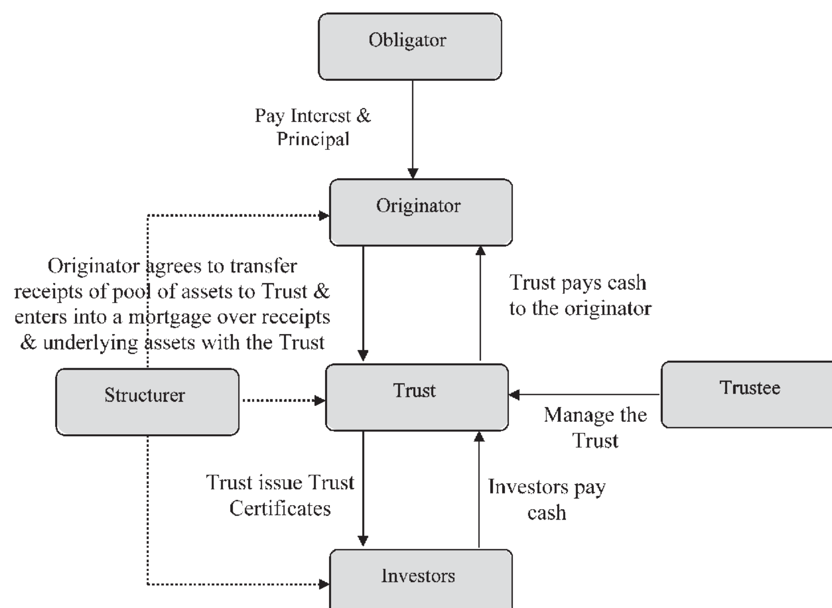
The shape of the securitisation market will be determined to some extent by external factors such as macroeconomic conditions and stabilization and recovery of the housing market in many countries. Four key priorities for action identified by the industry were to:

- Improve disclosure of information on underlying assets in residential mortgage backed securities
- Enhance the transparency with regard to underwriting and origination practices
- Restore the credibility of credit reference agencies
- Improve confidence in valuations, methodologies and assumptions.

Securitisation in Sri Lanka

Securitisation in Sri Lanka actively started around year 2003, before which only very few securitisation transactions had taken place. Securitisation of housing loan receivables of Housing Development Finance Corporation (HDFC) in late 90s, was one of the major securitisation in the history of securitisation market in Sri Lanka and was structured using the true sale concept. Securitisation in Sri Lanka adopts a trust structure with the underlying assets being mortgaged to a trustee. Although a trust is not a legal entity, a trustee is entitled to hold property, which is distinct from the property of the trustee or other trust properties held by him. Thus, the trust is termed as a Special Purpose Vehicle (SPV) which issues securities to the investors. However, true securitsation practice is not adopted in Sri Lanka due to various reasons.

Securitisation Transaction Model Adopted in Sri Lanka



The following table contrasts true securitisation vs present securitisation practice in Sri Lanka.

True-securitisation	Present practice
Pass the liability to SPV	Originator is liable
No involvement of issuer	Originator is liable
Cash collection and investment handled by trustee	Cash collection handled by the originator
Separate rating for SPV	Rating is not available
SPV bear the total risk	Risk is minimal for the trustee
Higher risk for the investors	Low risk to the investors
Off–balance sheet of the originator	On-balance sheet of the originator

The need for securitisation in Sri Lanka exists in three major areas ie MBS, the infrastructure sector, and ABS. Financial institutions/banks have made some progress in financing of auto loans. With the introduction of financial sector reforms in the early 2000s, financial institutions/banks, particularly the non-banking financial companies, have entered into the retail business in a big way, generating large volumes of homogeneous classes of assets (such as auto loans, real estate). This has led to attempts being made by a few players to get into the ABS market as well. However, still a number of legal, regulatory, psychological and other issues are to be sorted out to facilitate the growth of securitisation in Sri Lanka.

The Finance Leasing Act No 56 of 2000 has a provision to transfer or assign lessor's rights on finance lease to a special purpose vehicle for the purpose of securitisation. However, when analyzing the volumes of leasing transactions, it clearly indicates that companies have not used securitisation to the potential level.

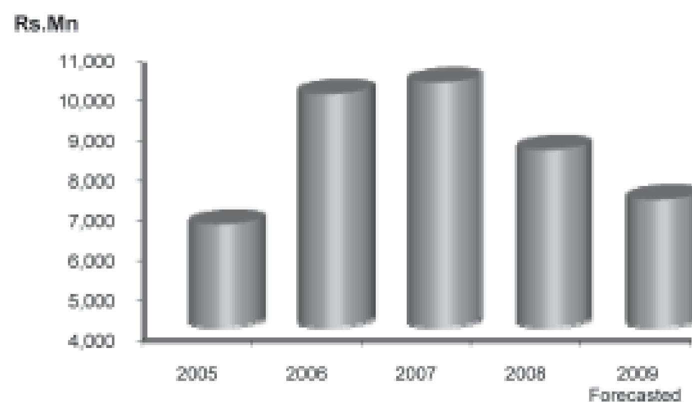
Value of Leasing Facilities Granted

Source: CBSL Annual Report, 2004, 2006, 2008

Market activity

Until 2007 securitisation market in Sri Lanka showed a Compounded Annual Growth Rate (CAGR) of 24%. In 2008, it showed a negative growth of 16.6% YoY mainly due to the concerns over the global financial crisis and the latest available figures show that this will continue in the year 2009 too. In year 2007, Rs.8.8 billion was raised by the securitisation of vehicle loans. Securitisation of vehicle loans, amounts to 75% of total securitisations in the country, while housing, rentals and plantation account for 10%, 10% &5% respectively. During first half of 2009, the securitisation market in Sri Lanka has shown a clear down fall over the previous year, in both value terms and number of transactions. The following graph depicts volume of securitisation transactions from 2005 to 2009(forecasted).

Volume of Securitisation Transactions in Sri Lanka



Computed by Author based on market information

Some of the main features in the SL securitisation market are;

- Most of the securitised issues, tenor is less than 4 years.
- There are around 56 finance/leasing companies operating in the market. However, only around 16 companies have raised funds through securitisation.
- Most of the small leasing and finance companies do not have a credit rating.
- Inadequacy of number of investment bankers and structurers.

Obstacles to asset securitisation in Sri Lanka

I. One of the biggest hurdles facing the development of the securitisation market in Sri Lanka is the unavailability of legislation to govern the securitisation transactions. Although

the draft act has been finalized to regulate the securitisation industry in the country, it is yet to be presented to the Parliament. At present there are no specific laws governing recognition of income of various entities in a securitisation transaction. Certain trust SPV structures actually can result in double taxation and make a transaction nonviable. Securitisation legislation should specify requirements for off-balance sheet or on-balance sheet treatment for securitisation and regulatory capital requirements for originator and investors.

II. Lack of effective foreclosure laws also prohibits the growth of securitisation in Sri Lanka. The existing foreclosure laws are not lender-friendly thus increase the risks of MBS by making it difficult to transfer property in cases of default.

III. Assets Backed Securities are not explicitly covered under the Securities and Exchange Commission (SEC) Act's definition of securities. To remove ambiguities relating to the inclusion of the ABS or PTCs and their subsequent listing with the stock exchanges, the regulators should consider to include ABS or PTCs and other securities issued by the SPV trust as 'securities' under SEC Act.

IV. Underdeveloped debt market is always a drawback for securitisation. The propensity for long-term exposures of more than 5 years is low in the Sri Lankan debt market. Developments in this sector can increase the securitisation activity in Sri Lanka.

V. In Sri Lanka, the awareness factor and an insight of the process of securitisation are abysmally low. The onus lies on the regulators and other various organisations to educate and involve corporate investors in securitisation processes. A mandatory rating of all structured obligations will provide the investors with credibility about the transactions taking place.

Outlook at the securitisation industry in Sri Lanka

The retail lending business in Sri Lanka is expected to grow with the new development opportunities created from the establishment of the peace in the country. Banks, particularly those active in the retail finance business are likely to face capital constraints in the expected growth phase. In this context, the regulator needs to take new measures on capital adequacy, for Basel II compliance, which offers the prospect of capital relief on securitisation which could be a factor in motivating banks to securitise some of their assets. Besides providing capital relief, securitisation acts as a funding source and a means of matching asset-liability tenures. Currently, many smaller originators are also finding it difficult to access funds on a scale that matches their business growth ambitions, and are likely to turn to securitisation as a result. Auto loans will be the dominant underlying asset classes since these have better asset quality and therefore attract lesser credit enhancement. Personal loans may also be securitised to a greater extent, given the higher growth rate in this asset class.

Since Asset Backed Securities do not yet have the status of 'securities', they are ineligible for listing in stock exchange. Therefore, we need to amend the SEC Act to pave the path for creation of a legal framework for listing and trading of ABS in the Colombo Stock Exchange. Further, the recognition of ABS as 'securities' will make them eligible for investment by foreign investors, thereby widening the investor base for these instruments.

With the successful completion of humanitarian operations in the North and East the expectation of economic prosperity of the country is at a high level. The demand for credit is expected to grow in the coming years with many development activities taking place in the country. Banks and other financial institutions will have to find funds to meet the increasing demand for credit. In that context, securitisation will play a significant role in providing the required funds to the banks and other financial institutions.

Conclusion

There are number of factors that have contributed to the collapse of the securitisation market. Some of these factors are; increasing delinquency rates in sub-prime mortgages in the US, intense competition among lenders and low quality lending, off-balance sheet exposure of banks, rapid development of complex financial products through asset securitisation, outside the regulated entities, lapses of credit rating agencies and lack of transparency in the market.

However, we need to learn from the current collapse of the securitisation markets and take measures to avoid such incidence in developing the asset securitisation market in Sri Lanka. In this context, the draft securitisation bill needs to be amended to address the recent development in the global securitisation markets and in order to ensure financial system stability, regulators & supervisors will have to play a major role in monitoring and supervising the securitisation transactions and issue new guidelines covering banks and other financial institutions covering securitisation transactions.

There is a basic question raised by many people on securitisation after the sub- prime crisis,

"If there was nothing wrong in securitisation, why did we have all these problems? "

It is like, a person driving a car in a crazy manner, and then meeting with an accident.. He then says, cars are bad and should be removed from the road.

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