

Securitisation – Unlocking Potential

Good morning Ladies and gentlemen –

Introduction

My remit today is to talk to you on the benefits of securitization for the restructuring of financial institutions. I am not sure that I am going to be able to do justice to this subject because, as we all know, and I do not need to labour the point, securitization, in whatever form, still remains uncharted territory in Sri Lanka, although it has much potential - So, as is the theme of this seminar, we need to unlock its potential.

My words today are, largely, going to be on my limited experience of what I think have been a few attempts at securitization in the banking industry and, from my limited knowledge of what securitization is, how I feel it has helped restructure financial institutions globally (here I have borrowed from an E&Y study on Global Non-Performing Loans) and then, from a regulator's point of view, what are its attendant risks.

Securitisation in the banking industry in Sri Lanka

As a means of restructuring financial institutions, and I can talk only of the banks, asset backed securitization has been used very marginally, by, perhaps, one small commercial bank when it was being restructured. Its large non-performing portfolio was transferred to a SPV, under a **deemed** securitization transaction. By doing so, the poorly capitalized bank was able to clean up its balance sheet and transform its hitherto non-earning asset portfolio into performing assets i.e. in the form of a bond of 20 year maturity for the value of the portfolio which was accounted for as investment securities. To qualify for investment quality, the SPV which was, hitherto, unknown, got a large commercial bank to guarantee the bond. The credit enhancement granted to this bond is recognized as a liability by the guaranteeing bank. The recoveries of the NPA by the SPV boosted income, thereby augmenting income. I am quite sure that it does not qualify as an asset backed securitization in the true sense of this mode of financing. . These are ad hoc measures taken to suit specific situations and are really hybrids. A similar scenario was envisaged for the restructuring of the failed Pramuka Bank by one of the parties who submitted proposals.

HDFC Bank's securitization is recorded as the only "true sale" securitization hitherto in Sri Lanka.

However, since this activity is not regulated, the need for approval of the Central Bank and what is referred to as a "convoluted structure" just to be able to preserve parate rights, has taken place. Thus, the whole transaction is opaque but has given the HDFC, which is unable to raise adequate deposits to fund its operations, much needed liquidity against its illiquid, long-term home loan receivables. The legal ownership still resides in the HDFC which has, through the pass through certificates (PTCs), passed on the beneficial ownership to the SPV. Citibank was the arranger and Deutsche Bank was the trustee. This transaction really transformed HDFCs long term receivables into immediate liquidity which it was able to use to acquire more assets. However, it did not free capital. Now this was a conscious decision, I am told, of the HDFC because it already had excess regulatory capital. The approval of the regulator was also necessary to transfer assets from its books which was tardy. I was also told that the borrower's consent had already been incorporated into the mortgage bonds. So here we have a case where the legal ownership remains with the HDFC and the beneficial ownership passes on to the SPV. The securities were highly rated and were fully subscribed. The HDFC informs me that the costs of this transaction were excessive unless the scale was much higher.

So while the former illustration was capital insolvent, the latter was liquidity insolvent. In both cases, thus, this so-called securitization has been beneficial in restructuring the balance sheets of the banks.

Now why do we say that these scenarios do not fall strictly into the ABS mode? They, however, satisfy certain basic criteria –

In the case of the restructured bank, it removed the assets from the balance sheet, thereby liberating capital allocated to these assets for other uses and enabled restructuring of the balance sheet, and it resulted in non-performing receivables being replaced by performing investments; in the latter, it transformed long term receivables into immediate liquidity for the bank.

However, what were the risks?

If not carried out prudentially, certain risks can still reside with the originating bank, without capital to back these risks, because these assets are no longer on the bank's balance sheet, that is if, indeed, a "true sale" securitization has taken place. The risks, therefore, arise in this instance from the fact that a "true sale" has not been achieved and the originating bank is forced to recognize some portion of the losses, if the assets transferred to the SPV cease to perform – as is very often the case with non-performing assets. Now, that is exactly what we see happening in the former case. The anticipated recovery is not taking place and there is dependence by the bank on this revenue. The anticipated income streams are not materializing.

I understand that a securitization by novation is a *per se* securitization transaction. I am sure the experts here have explained to you what that means. These illustrations do not have the most important characteristics of securitization by novation.

Securitisations from a global point of view in aiding the restructuring of banks -

NPL disposition strategy

Basically, what are we looking at? - Of paramount importance in any business and, particularly, in banks which are highly leveraged institutions – that is they have very little capital and operate, primarily, on borrowed funds – that is why they are regulated and have to satisfy minimum, statutory, capital requirements - is that you cannot solve a problem until you make a very candid, accurate and complete assessment of the problem. (Recognition). Once it is recognized and identified, it needs to be quantified or measured and then mitigated through adequate resources allocated to cover the risk. Now this is why we have imposed requirements for the statutory disclosure of key financial indicators of banks, one of the most important of which is, the NPA ratio. As you know, the advances portfolio of a bank is its major earning asset – therefore asset quality assumes paramount importance. Now our experience is that banks always tend, through various means, to underestimate the magnitude of their NPL problems – this is common the world over - why? It affects their profitability and consequently their capital. Unearned income on NPA is required to be suspended and not recognized as income. We never tire of telling the banks that they are only fooling themselves in not recognising and understanding the problem of default. A prudent bank should be recognising impairment at the very first signs to be able to nip it in the bud. – because if you fail to recognize the problem you will fall short of your efforts in resolving the problem. Data on credit default and income earned but not received is vital management information.

How do banks deal with NPAs?

- Banks generally tend to do one of three things – they either do nothing, expecting the conditions that brought on the NPL to go away and later right itself, but as a result the NPL deteriorate even further; the value of collateral also declines and the NPL which were only overdue now become even worse down the classification line, requiring even more capital and can result in losses.
- Then there are banks that try to postpone the problem and that is very common – by rescheduling the NPL – some banks are very smart – just before they hit NPL status, they reschedule them and dress them up as if they were new loans – we cannot even recognize them they are so smartly dressed up. There is a regulation governing rescheduled loans as well.

- And of course there are always the prudent banks which are vigilant, have many NPA disposition strategies and take fast, decisive action to stem the deterioration . In other countries strategies are adopted to move the NPAs off their balance sheets to AMCs, securitization, bulk sales, through work-outs and restructuring etc. One must remember that at the nascent stage of their default – they can be easily transferred to a buyer as the possibility of recovery is very strong even to the investor, as cash flows are predictable. However, at a very late stage of default, where hard core has set in and all avenues of recovery have failed, even an investor will not be happy to invest and the value you can get is minute. AMCs just serve as warehouses for such debt as they clearly have no value.

Securitisation as a NPL disposition strategy

Securitisation has served successfully as a restructuring strategy in several countries – in the U.S during the Savings & Loan crisis, where the present and future cash flows of the NPLs were securitized, and in Japan, by the Resolution and Collection Corporation and by private investors and in Thailand and Korea by NPL investors. For securitization to work in this manner the pre requisites are - mature NPL markets with predictable cash flows, a sound financial system with rating agencies and special servicers or joint venture partners. Countries which have these pre-requisites such as Japan, China and Korea have provided the happy hunting grounds for global investors who have been able to get returns of 20% or more from high-risk NPL acquisitions. They buy a loan for 20% of the book value and negotiate with the borrower to receive upto 40% in exchange for debt forgiveness. This way, through initiatives taken by governments and banks, more than U.S.\$ 1 trillion have been removed and another 1.3 trillion U.S.\$ still await resolution.

So securitization affords many opportunities to develop and implement strategies to restructure bank balance sheets and rid them of their NPLs. The legal mechanism must be created by the government - it will particularly help the state banks both commercial and specialized, which have large NPL portfolio in their books – the carrying cost of which is very high, as they have very high and prudent levels of provisions against them– it will free the significant amounts of capital that are presently allocated to these NPLs, which can be used more productively. For their part, banks must provide an open, accurate and candid accounting of their NPLs, and develop their own disposition strategies and take swift action to put them into action. Investors too must have well-thought out entry and exit strategies and must even consider the use of global advisors who should be willing to work closely with the banks and the government on NPL dispositions and the restructuring of the banks.

What are the regulatory requirements which are of supervisory concern?

There is clearly a need for a robust, legal and procedural framework, including prudential regulations which are not stifling but will protect the bank from the risks of securitization. As has been pointed out, the duplication of regulation must be avoided and there should not be overlaps. – a very pragmatic regulatory environment is what is needed. We will borrow heavily from India, the U.S. and from the UK which have large securitization markets and have expanded from home loans to credit cards, consumer loans and other receivables.

It is important that the development of prudential guidelines to facilitate these transactions should not be in conflict with the securitization law that is proposed.

At present there is a lack of understanding and clarity of the approvals necessary for a regulated financial institution to securitise its assets – I think I discussed this with Ms. Adby;

The Finance Leasing Act, as amended, requires approval by the CBSL for leasing companies – however, so far, none of the leasing companies have resorted to true securitization of their receivables – what they have accomplished is really a mortgage of their receivables. However, in most countries it is lease receivables that are securitized. I think here what counts is investor confidence which can only be won by a good rating.

Another important aspect is the qualifying criteria for SPVs which should be independent and not a related party as this can lead to abuse. Recently such a transaction was resorted to where the SPV was a related party and it was an attempt to clean up or dress up its balance sheet for publication. The SPV, a related party had been formed just for this purpose - now what concerned us as regulators was that the “bankruptcy remoteness” of this party was certainly called into question and it was felt that at some point it was going to have recourse to the Bank concerned which made out that it was free of this portfolio in lieu of consideration having been fully paid. Although they had gone through the procedure of a Trust etc. the fact that it was just before the final accounts and the related party concern were of serious supervisory concern. We therefore required the auditors to take full responsibility for the bona fides of this transaction.

Some of the regulations proposed by the Financial Services Authority, UK under Basle II are as follows:- To be able to exclude securitized exposures from the calculation of risk weighted exposure they must –

- Explicitly meet the definition of a securitization
- Implicit support from an originating firm to a securitization transaction which is beyond its contractual obligations, with the view of preventing actual or potential losses to investors, is prohibited as it would result in both risk and regulatory capital being understated.
- Buying back securitized exposures is prohibited

To conclude, may I quote from the Basle Committee on Securitisation for Basle II, – *By its very nature securitization relates to the transfer of risks associated with the credit exposures of a bank to other parties. In this respect, securitization is important in helping to provide better risk diversification and to enhance financial stability. The securitization framework and its capital impact for originating banks are premised on the expectation that securitization is used to transfer significant levels of credit risk. We, as supervisors need to ensure that this is, indeed, the case and that capital requirements for securitization transactions reflect risk appropriately.*

Thank you.

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