e-Resources Module-IV

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ASSET SECURITIZATION

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In recent years, Asset Securitization has turned out to be a useful financial innovation across various financial markets of the world. Under asset securitization, different financial intermediaries typically pool together their assets i.e. loans and against their backing, issue tradeable securities in the market. As these loans are of various maturities and amounts or denominations, it offers services similar to 'maturity intermediation' and 'denomination intermediation' to a wide variety of investors. In addition, the financial intermediaries such as commercial banks converting their assets into tradeable securities in this manner, may hire the services of specialised agencies for servicing the loans and could also engage insurance agencies to get credit risk insurance. In order to distribute the concerned securities to potential investors, the financial intermediaries undertaking "asset securitization" have also been observed to hire the services of securities firms for operational convenience. In actual practice, asset securitization has been practised in numerous cases ranging from automobile loans and housing loans viz., issuing of mortgage-backed securities to the case of 'viatical settlements.' Asset securitization tends to benefit all the relevant agents operating in financial markets. For instance, it provides an alternative source of funding to the issuers of the concerned securities thereby helping them in expanding their business. Likewise, asset securitization enables potential borrowers i.e. productive deficit investors to get the funds desired by them as without this arrangement, they could quite conceivably have been deprived of the requisite financial resources. As far as investors in concerned asset-backed securities are concerned, they too are benefitted in as much as they get access to investing in securities that are relatively safer and promise a reasonable return alongside.

Whenever new financial assets are introduced in an economy in order to cater to the diversified needs of asset holders or new financial services are devised with a view to raising the efficiency of the financial sector, a financial innovation is said to take place. Thus construed, financial innovation is nothing but new ways of doing things so as to raise financial efficiency in an economy. Asset securitization is one such "financial innovation" that the financial systems of various countries have witnessed in recent years.

More specifically, "Asset Securitization" implies the conversion of Assets of financial institutions into Securities tradeable in the market. When marketable securities are issued against the backing of assets such as loans given by financial institutions in this manner, it proves to be beneficial to all the relevant agents operating in the financial markets. This can be easily established by comparing asset securitization with "indirect finance" *i.e.*, the traditional system of financing based on financial intermediaries.

Under indirect finance, an intermediary such as a commercial bank mediates between the savers or 'ultimate lenders' in an economy on the one hand and productive deficit spenders *i.e.*, entrepreneurs or 'ultimate borrowers' on the other. To put it simply, a financial intermediary like a commercial bank typically mobilises its resources in the form of deposits from the public and in turn lends them to real physical investors as loans & advances which are treated as assets in its balance sheet.

Now since deposit mobilisation by commercial banks or other financial intermediaries in an economy can at times fall below the demand for loans, it is quite conceivable that genuinely productive economic activities may suffer due to the lack of requisite funds as several genuinely productive entrepreneurs may simply keep waiting for loans desired by them. It is precisely under these circumstances that "Asset Securitization" proves to be a useful financial innovation for all the parties concerned.

To be precise, in the absence of sufficient funds mobilisation through deposits, several commercial banks may join hands and pool together their loans and simply issue tradeable securities in the market against the backing of those loans or assets in their balance sheets. This way, their illiquid assets are converted into highly liquid and marketable securities thereby providing them access to an alternative source of funding. If such an "asset securitization" would not have taken place, the borrowers would have been deprived of the loans desired by them and the business of commercial banks and other such financial intermediaries involved would also have remained curtailed. As far as those investing in such securities are concerned, they too are benefitted in as much as securities backed by the loans or assets of financial intermediaries are relatively safer and promise a reasonable return alongside.

It is worth noting that since under "asset securitization", typically several financial intermediaries "pool together" their loans of various 'maturities' as well as amounts or 'denominations', it entails services similar to both "maturity intermediation" and “denomination intermediation” whereby varying maturities and denominations are offered to a wide range of investors.

In this way, asset securitization turns out to be a useful financial innovation that benefits all economic agents involved, be it financial intermediaries as issuers of asset-based securities or those investing in concerned securities or even the borrowers from financial intermediaries.

In actual practice, asset securitization has been practised in numerous cases ranging from automobile loans to housing loans *viz.*, issuing of mortgage-backed securities. Of late, even “viatical settlement” has also come into practice in some countries such as U.S.A. whereby securities backed by insurance policies purchased from individuals with terminal illness have been issued.

It has also been observed in actual practice that with a view to effectively implementing asset securitization, the financial intermediaries pooling together their resources often hire the services of a “securities firm” so as to distribute the concerned securities to potential investors. Likewise, many a times, the financial intermediaries concerned engage insurance companies in order to get credit risk insurance for the pool of loans at hand and employ specialised agencies for the servicing of loans.