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Indian Securitization Market: The Pros and Cons

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Abstract

Securitization is a financial instrument has had an extremely significant impact on the world's financial system because it integrates capital markets and the uses of resources such as originators, mortgage, governments, finance companies, etc. Securitization has strengthened the trend towards disintermediation. Having been able to minimize agency costs, it has made lending more efficient; Evidence of Securitization can be observed in the mortgage markets. By permitting firms to originate and hold assets off its balance sheet, it has generated higher levels of leverage and greater economies of scale. In India securitization is getting popular due to its effectiveness. The combination of securitization techniques with credit derivatives and risk transfer devices are continued to develop innovative methods for minimizing risk, The risk can be transformed into a commodity which allow the various market participants and investors to enter into the sectors which were otherwise not open to them.

1. INTRODUCTION

In modern economy, the term securitization has acquired a more specific meaning, which for the sake of distinction it is referred to as "asset securitization." A securitization transaction transforms assets into securities and achieves the purpose of providing financing, but in a unique way – by sale of assets. While the result of a securitization transaction is that financing is obtained but it is not "financing" as such because the entity securitizing its assets is not borrowing money and creating liability but selling a stream of cash flows that was otherwise to accrue to the entity. For this the entity could be a corporation (financial or nonfinancial) or a government entity. The basic purpose to write this article is to explain the basic principles of securitization, the reasons for its use by corporations in India, and its impact on Indian financial market.

2. THE SECURITIZATION PROCESS

The securitization is a financial transaction, in securitization assets (Debtors) are pooled and securities which are having interests in the pool are issued. The only requirement is that each assets pool must be homogeneous with respect to credit, maturity and interest rate risk. An example would be a financing company that has issued a large number of auto loans and wants to raise cash to issue more loans. One solution would be to sell off its existing auto loans, but there is not a liquid secondary market available for individual auto loans. Instead, the firm pools a large number of its auto loans and sells interests in the pool to investors. For the financing company, this raises capital and gets the loans off its

balance sheet, so the company can issue new loans. For investors, it creates a liquid investment in a diversified pool of auto loans, which may be an alternative to a corporate bond or other fixed income investment. The ultimate debtors—the car owners—need not be aware of the transaction. They continue making payments on their auto loans, but now those payments flow to the new investors as opposed to the financing company.

The assets which are generally securitized are auto loans, student loans, mortgages, credit card receivables, lease payments, accounts receivable, corporate or sovereign debt, etc. these assets are often called collateral.

In a typical arrangement, the owner or "originator" who pools the receivables in to assets, sells those assets to a special purpose vehicle (SPV). This may be a corporation. It is established specifically to facilitate the securitization. It may hold the assets which are collateral on its balance sheet or place them in a new separate trust. Otherwise, it can sell bonds to investors. The SPV uses the proceeds received from that bond to pay the originator (owner) for the assets.

Most of the collateral also requires the performance of ongoing servicing activities. With credit card receivables, monthly bills must be sent out to credit card holders; payments must be deposited, and account balances must be updated. Similar servicing must be performed with auto loans, mortgages, accounts receivable, etc. Usually, the originator is already performing servicing at the time of a securitization, and it continues to do so after the assets have been securitized. It receives a small, ongoing servicing fee for doing so. Because of that fee income, servicing rights are valuable. The originator may sell servicing rights to a third party. Whoever actually performs servicing is called the servicing agent. Cash flows from the assets—minus the servicing fees—flow through the SPV to bond holders. In some cases, there are different classes of bonds, which participate differently in the asset cash flows. In this case, the different bonds are called tranches. If the securitization is structured as a pass-through, there is only one tranche, and all investors participate proportionately in the net cash flows from the assets.

When assets are transferred from the originator to the SPV, it is critical that this be done as a legal sale. If the originator retained some claim on those assets, there would be a risk that creditors of the originator might try to seize the assets in a bankruptcy proceeding. If a securitization is correctly implemented, investors face no credit risk from the originator. They also face no credit risk from the SPV, which serves merely as a conduit for cash flows. Whatever cash flows the SPV receives from the collateral are passed along to investors and whatever party is providing servicing. Collateral will typically pose credit risk. For example, people may fail to make their credit card payments, so credit card receivables entail credit risk. This can be addressed with some sort of credit enhancement such as over-collateralization or a third party guarantee.

With a securitization, the party underwriting credit risks is not the party taking that credit risk. This opens the door to various abuses. Such abuses, especially with regard to securitizations of subprime residential mortgages, were a primary cause of the2008 financial crisis.

Standard Categories of Securitizations:

- Mortgage-backed securities (MBS), these securities are backed by mortgages;
- Asset-backed securities (ABS), which are mostly backed by consumer debt;
- Collateralized debt obligations (CDO), which are mostly backed by corporate bonds or other corporate debt.

Asset backed security: The securities issued by the SPV are referred to as asset backed securities.

These securities differ from a usual capital market instrument which is an exposure to the issuer's business. An asset backed security is simply an exposure to a pool of specified assets. The investors who acquire these securities are not concerned with the generic risks of the business of the originator company. Even the bankruptcy of that company cannot affect investors, though there will be some shock to the servicing function if it is being performed by the originator company.

The investors are, however, exposed to the risks of the asset pool. These risks may be multifarious for example, delays, defaults, prepayments, legal challenges, and so on. What is critical to understand is that investors in the asset backed securities are exposed to the risks of the asset pool not the risks of the originator company's business. Therefore, an asset backed security is not a claim on an entity but a pool of assets.

` If we talk about India, there has been sufficient amount of activity are going on in the Auto Loan securitization market. Companies like Magma Leasing, TELCO, Kotak Mahindra and Ashok Leyland Finance have been securitizing their portfolio made of auto loans to the buyers like Citibank and ICICI over the past 3-4 years, and several of the transactions were rated by rating agencies such as ICRA and CRISIL. While many deals out of total deals are bilateral buyouts in the form of portfolio, ICICI bank has used its SPV structure and then placed all the issuance privately and directly to investors from corporate and banks.

While the activities in the Assets Backed Security market are going up in India, the investors are very limited in securitized paper. There are legal and taxation uncertainties are associated with securitization system, because of the absence of a Securitization Act in India. In securitization, secured assets are transferred which can attract a stamp duty equal to 10% in some areas precluding possibilities of transaction. In India, favorable taxation and legislation regime, for ABS market, can hope and induce a lot of activity in future.

Mortgage Backed Securities (MBS): In the US, about 76% of the market of securitized debt is constituted by MBS. While in India, the MBS market is nascent - National Housing Bank (NHB), in partnership with HDFC and LIC Housing Finance, issued India's first MBS issuance in August 2000. The potential of MBS in India, however, is huge. With NHB actively looking towards the development of a Secondary Mortgage Market (SMM) in the country, In India the MBS market can overtake the other transactions of securitization in the country. This market can help small and medium Housing finance Corporations which have good origination capabilities and strength of balance sheet is limited in staying profitable in future and can concentrate on the origination of housing loan. The absence of mortgage foreclosure norms and the high rate of stamp duty for mortgage assignment are important roadblocks for MBS in India.

Collateralized Debt Obligations (CDO): CDOs are helpful for banks and financial Institutions to manage their portfolio proactively. Banks also can restructure their stressed assets with help of CDOs. In August 2000 the ICICI had made an attempt which had aborted to do an issuance of CBO. In India the CDO market is, growing slowly due to its complexities. The clarification is required regarding accounting treatment and taxation for CDOs in India.

3. INDIAN SECURITIZATION MARKET

The growth in the Indian securitization market has been largely fuelled by the repackaging of retail assets and residential mortgages and more recently by single loan sell-off of corporate loans of banks and other financial entities. This market which has been in existence since the early 1990s has matured only post-2000 with an established narrow band of investor community and regular issuers. Asset backed securitization (ABS) is largest in its class of securitization which is driven by the growing portfolio of retail loan of banks, familiarity of investors with the underlying assets and the maturity period of these loans.

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 more recently, even microfinance loans have been securitized. Within the auto loan segment, the car loan segment has been more successful than the commercial vehicle loan segment, mainly because of factors such as perceived credit risk, higher volumes and homogenous nature of receivables. Other types of receivables for which securitization have been attempted in the past includes property rental receivables, power receivables, telecom receivables, lease receivables and medical equipment loan receivables.

The mortgage backed securities (MBS) market has been relatively slow in taking off despite a growing housing finance market due to the long maturity periods, lack of secondary market liquidity and the risk arising from prepayment/re-pricing of the underlying loan. Unlike many international jurisdictions, though, MBS in India has not depended on direct or indirect government support/ guarantee.

In the recent times, direct assignment of single loan or retail loan pools (as against securitization involving a special purpose vehicle or SPV) has been gaining importance in India. The broad structure of such transactions is similar to that of regular ABS or RMBS transactions, except for the absence of the issuance of any instruments like PTCs. The pool receivables in such cases are assigned directly to the "assignee" or "purchaser". Such deals typically involve a bank or a mutual fund acquiring the portfolio from other banks or NBFCs. The choice of the route, "direct assignment" or "securitization" depends largely on investor preference and such deals are customized to meet the requirements of investing entities. For instance, while MFs can invest only in "instruments", banks often prefer to acquire loan portfolios outright, as PTCs—by virtue of being investments— would need to be marked to market, and loans and advances do not have such requirement. Further, for the purchasing banks, the attraction is that many of such loans qualify for the Priority Sector Lending (PSL) requirements.

From a regulatory perspective, the real issue is that of regulatory arbitrage. While there is nothing wrong in direct sale of loans, banks should appreciate that if these transactions are being done to avoid restrictions on profit booking and higher capital requirements for credit enhancements, RBI would have concerns. As a prudent practice, banks should apply regulatory instructions according to the substance of transaction rather than form.

4. RECENT TRENDS

Though the securitization market in India is marked by relatively simple structures and stable ratings, concerns over asset quality have affected investor appetite for securitization in the post-crisis scenario. Much of the securitization activity is driven on the supply side by growth of retail loan portfolio in banks and NBFCs and the prevalent liquidity conditions. On the demand side, the key factors have been the requirements of mutual funds, particularly at the short end, insurance companies and banks to meet priority sector lending targets. Most of the securities are acquired with the intention to hold to maturity.

As per the data compiled by major rating agencies, the year 2009-10 has witnessed an overall moderation in the volumes in securitization market. Total issuance volume saw a decline of 22% in 2009-10 over the previous fiscal. The dip in the overall securitization volumes owed mainly to the 60% reduction in loan sell-off (LSO) issuances, which were mostly short-term in nature. In the case of retail loan-backed transactions, with the overall growth in retail loan portfolios being subdued and the liquidity position of most financiers being comfortable, the need to securitization as a funding source was limited. Nevertheless, securitization of retail loans, both ABS and RMBS reported a 61 per cent increase in volume in 2009-10.

While the securitization market has remained concentrated with a handful of originators and limited investors, the asset classes have continued to diversify, the latest additions being gold loans, microfinance loan receivables and loan against property.RBI had issued comprehensive guidelines on securitization in February 2006 based on international best practices. The main focus of the guidelines was to encourage securitization in manner that ensures true sale -real risk transfer and banks do not retain risks in the transferred assets beyond a point. To this end, limit was placed on banks' exposure to PTCs and concentration of entire credit enhancement in the originating bank was discouraged by making second loss facilities more costly through higher capital adequacy. Banks are however permitted to invest outside the prescribed limit for non-listed investments in ABS and MBS which are rated at or above the minimum investment grade.

Another feature of the 2006 guidelines was the requirement that the gain on securitization of assets

Table 1: Trends in Structured Finance Volumes (Rs. billion)

Type	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
ABS	12.9	36.4	80.9	222.9	178.5	234.2	313.2	135.8	209.7
MBS	0.8	14.8	29.6	33.4	50.1	16.1	5.9	32.9	62.5
CDO/LSO/SLSD	19.1	24.3	28.3	25.8	21.0	119.0	318.2	364.4	145.8
OTHERS	4	2.3	0.5	26	-	-	13	11.6	7.9
TOTAL	**36.8**	**77.8**	**139.3**	**308.1**	**249.6**	**369.3**	**650.3**	**544.7**	**425.9**

(CDO: Corporate Debt Obligations, LSO: Loan Sell off, SLSO: Single Loan Sell-down)Source: Various Rating agencies like ICRA, CRISIL etc

should not be recognized upfront and should be amortized over the life of the securities issued. This requirement was put as a conservative measure to avoid securitization being used to inflate profits even while banks exposures in various capacities to the SPV remain.

After market showed some maturity, the capital adequacy treatment was aligned with that under Basel II in April 2007.

The recent draft guidelines issued in April 2010 stipulate a minimum holding period (MHP) and a minimum retention requirement (MRR) by the originators. The guidelines envisage MHP of 9 months and 12 months respectively for loans with maturity of less than 24 months and more than 24 months. Similarly, the MRR for loans with maturity of less than 24 months and more than 24 months has been proposed as 5% and 10% respectively. Banks will not be permitted to hedge the credit risk in the retained exposures counting towards the minimum retention requirements.

The guidelines further stipulate that the total exposure of banks to the SPV and/or securitized assets in the form of investments in equity/ subordinate/senior tranches of securities issued by the SPV including through underwriting commitments; Credit enhancements including cash and other forms of collaterals including over-collateralization and liquidity support should not exceed 20 percent. Complex securitization structures viz. re-securitization, synthetic securitizations and securitization with revolving structures are specifically prohibited.

Similar guidelines have also been issued in respect of securitization transactions undertaken by NBFCs. The feedback received mainly briefly relates to the following:

a. Level playing field between banks and NBFCs as regards MRR and MHP – On the one hand, there is a view that given the intrinsic nature of loans given by the NBFCs, particularly in the microfinance sector, stringent requirements may hamper lending in these critical areas. On the other, there is the regulatory arbitrage issue which necessitates ensuring that the incentive structures do not again result in a shadow banking system.
b. Applicability of the guidelines to direct assignment transactions.
c. Category-specific relaxations for MHP
d. Relaxation of MRR requirement for retail loans
e. Treatment of 'time-trenched' issuances as against 'credit trenched' issuances
f. Relaxation in respect of the 'total exposure' norm

RBI is examining the responses and the final guidelines for banks as well as NBFCs will be issued after taking into account the feedback.

5. CONCLUSION

Globally, over the past two decades, banks have lost their traditional role as the dominant suppliers of credit in some countries, and securitization has become a core component of the market-based supply of credit. While corporate bonds served as the main dis-intermediated financing tool for non-financial corporations, securitization acted as the main capital market instrument for household finance, and to a lesser degree SMEs. Post crisis, however, many of the pitfalls of the securitization market have come to the fore. Securitization has not been discredited totally though

the new normal for securitization markets is expected to be lower than its pre-crisis peak.
Covered bonds are considered an important part of this new normal particularly in Europe where it is permitted subject to safeguards. In this case the bonds are issued secured by high quality assets and both the liability and the assets remain on the balance sheet of the bank. The concentration of risks in the banking system remains which puts great strain on the health of the bank balance sheets. More importantly, it raises issues for the resolution regime given that the backing for depositors gets constrained.

The downside of securitization that has come to the fore is the absence of alternative solutions available to borrowers to restructure their loans when there is a downturn with the originator since the banker –customer relationship is snapped when the loans are securitized. Any restructuring requires consent of the final investors and in the long chain of intermediaries it becomes difficult to restructure debt. One of the reasons for the complexities of structures is that other derivatives such as currency and interest rate swaps are also embedded in some structures. This can be dealt with if these transactions are undertaken by the SPV and not embedded in the original structure.

In the Indian context, 'sustainable securitization' can indeed play a positive role in financial intermediation provided there is genuine transfer of risk away from the banking system. The existing and proposed guidelines are in line with international practices and may appear stringent but in the long term, it is imperative that securitization market develops for the right reasons. It is also necessary to promote standardization to facilitate risk assessment and valuation and eventually enable the trading of these securities on the exchanges.

There are a few challenges which need to be addressed.

- Bilateral assignments of a single loan or a portfolio that are in substance securitization should be subject to the guidelines on securitization.
- Though securitized paper issued by securitization SPVs has been recognized as 'security' under SCRA, there are still some tax issues relating to recognition of pass-through structure of the SPV.
- Substitution of long term funding by banks by other market intermediaries through securitization, particularly mortgage related securitization, may require active participation by real money investors such as long term institutional investors such as insurance companies and pension/provident funds and the investment guidelines for these entities need to accommodate this aspect.
- However it is also important to ensure that such investors have better access to essential information and less reliance on rating agencies. This will require dissemination of loan pool composition and ongoing performance detail.
- The reliance on rating agencies may be the default option, in the absence of a viable alternative. Some of the methodological issues, though, need to be addressed by the regulators.
- There are serious data issues and as regulators of banks and NBFCs, it may become imperative for the RBI and the SEBI to put in place a robust reporting mechanism for primary issuances as well as secondary market data.

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