Securitisation in India: Ambling Down or Revving up?

Financial sector's primary role is intermediation between ultimate savers and ultimate investors. Initially, it was banks which were the intermediaries. As the financial sector evolved, other types of financial institutions came on the scene to undertake such intermediation directly, or between and among other intermediaries. A parallel development is the emergence of varieties of financial products, far removed from simple deposits and advances, delivering such intermediation. Securitisation, as we all know, is among the latest of such intermediating product.

Securitisation – Definition

2. Securitisation is the financial practice of pooling various types of contractual debt such as residential mortgages, commercial mortgages, auto loans or credit card debt obligations (or other non-debt assets which generate receivables) and selling their related cash flows to third party investors as securities, which may be described as bonds, pass-through securities, or collateralized debt

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obligations (CDOs). Securitisation diversifies credit markets as it breaks the process of lending and funding into several discrete steps, leading to specialisation and economies of scale.

3. Securitisation actually has two major stages. In the first stage there is sale of single asset or pooling and sale of pool of assets by the owner of the assets ("**Originator**") to a 'bankruptcy remote' special purpose vehicle ("**SPV"**) in return for an immediate cash payment, and in the second stage repackaging and/or selling of the security interests representing claims on incoming cash flows from the asset or pool of assets to third party investors by issuance of tradable debt securities.

4. Thus in a nutshell, Securitisation is the process of taking an illiquid asset, or group of assets, and through financial engineering, transforming them into a security.

Advantages of Securitisation

5. Securitisation can offer a number of advantages for the stakeholders. Some of the benefits of the traditional vanilla securitisation products are as under:

For Originators

i. Securitisation frees up an originator's capital by removing the assets from the balance sheet. This way, capital is now available for origination of fresh assets with profitability potential.

ii. Through Securitisation, an originator with a relatively lower credit rating but with better rated cash flow would be able to borrow/raise funds against such higher rated cash flows at cheaper cost.

iii. It improves the liquidity position of the originator as the future receivables are replaced by cash.

iv. Securitisation can be used as a potent tool for re-balancing and re-distributing risks such as credit, market or liquidity risk or risk

concentrations on the balance sheet of the originator.

For Investors

For the investing parties, Securitisation offers different set of benefits.

i. It provides another option for diversifying their debt portfolio.

ii. It facilitates participation in relatively lower or higher risk portion of the cash flows, as per their own risk appetite.

iii. High rated and credit enhanced securities add to the safety of investments as well as capital savings for the investors.

iv. The presence of the ‘Pool Servicer” provides certain additional assurance and safety.

v. Securitisation allows flexibility in structuring the timing of cash flows to one’s needs.

For Servicers, Trustees, Credit Rating Agencies and Brokers

Securitisation offers added business opportunities and increased fee income.

For Financial Markets

Securitisation provides alternate debt instruments in the financial markets and improves market liquidity. It widens the markets and allow entry to new players. It enhances return on capital, diversifies financial markets, and serves as an alternate route of funding. Securitisation diversifies credit markets as it breaks the process of lending and funding into several discrete steps, leading to specialisation and economies of scale. Securitisation improves efficiencies in financial markets through risk diversification as the risks can be bundled and hived off and distributed among counterparties better equipped to manage these risks.

Regulation of Securitisation - Global initiatives

6. Securitisation emerged in the developed nations in 1970s as a financial innovation. The regulatory ethos of those days let the innovation thrive with least regulations. However, the lessons from the great financial crisis of 2008 activated a number of initiatives by the international standard setting bodies, regulators and governments for re-building investor confidence in the securitisation market. These initiatives were mainly aimed at addressing the concerns on conflicts of interest created by misaligned incentives and compensation systems for securitisers or originators within the securitisation chain, address information asymmetry within the securitisation process by increasing transparency of the securitisation structure, introduce risk retention or “skin in game” requirements and more stringent disclosure requirements, enhance oversight of credit rating agencies governance and reduce regulator reliance on ratings, better align the incentives of mortgage originators with those of investors in mortgage loans, standardization of disclosure documentation, etc. The

foremost among these are the Basel III Standards and enhancements to the Basel II Norms by BCBS, The Dodd Frank Wall Street Reforms and Consumer Protection Act in USA, Capital Requirements Directive (CRD II) and a proposal for a Directive on Alternative Investment Fund Managers Directive (AIFMD) in the European Union, issue of Disclosure *Principles for Public Offerings and Listings* by IOSCO, and other such directives/ guidelines by G20, FSB, etc.

7. As part of the Enhancement to the Basel II Norms in July 2009, the BCBS strengthened the treatment for certain Securitisation exposures under Pillar 1 (minimum capital requirements) and introduced higher risk weights for re-Securitisation exposures to better reflect the risk inherent in these products. It also required the banks to conduct more rigorous credit analyses of externally rated Securitisation exposures. The supplemental Pillar 2 (supervisory review process) guidance addressed several notable weaknesses that were revealed in banks' risk management processes during the GFC. The areas addressed include:

i. firm-wide governance and risk management;
ii. capturing the risk of off-balance sheet exposures and Securitisation activities;
iii. managing risk concentrations;
iv. providing incentives for banks to better manage risk and returns over the long term; and
v. sound compensation practices.

8. The Pillar 3 (market discipline) requirements have been strengthened in several key areas, including Securitisation exposures in the trading book; sponsorship of off-balance sheet vehicles; re-Securitisation exposures; and pipeline and warehousing risks with regard to Securitisation exposures.

9. Carrying forward, the BCBS has in December 2014, published revisions to address the shortcomings in the Basel II Securitisation framework and to strengthen the capital standards for Securitisation exposures held in the banking book. This framework, which will come into effect in January 2018, forms part of the Committee's broader Basel III agenda to reform regulatory standards for banks

in response to the global financial crisis and thus contributes to a more resilient banking sector. The most significant revisions relate to changes in:

i. the hierarchy of approaches;
ii. the risk drivers used in each approach; and
iii. the amount of regulatory capital banks must hold for Securitisation exposures (i.e. the framework's calibration).

10. The revised hierarchy of approaches reduces reliance on external ratings. It also simplifies and limits the number of approaches. At the top of this hierarchy is the Internal Ratings-Based Approach, which banks may use if their supervisors have approved their use of internal models. This is followed by the External Ratings-Based Approach - where credit ratings are permitted to be used in the jurisdiction - and the Standardized Approach. Additional risk drivers, notably an explicit adjustment to take account of the maturity of a Securitisation’s tranche, have been introduced.

11. Recently, a joint BCBS-IOSCO Task Force on Securitisation Markets (TFSM) undertook a review of securitisation markets in order to identify the factors that may be hindering the development of sustainable securitisation markets. TFSM has identified 14 criteria for introduction of Simple, Transparent and Consistent (STC) Securitisation structures which, if satisfied, could indicate that a securitisation transaction possesses minimal level of simplicity, transparency and consistency. The consultative document on criteria to identify STC securitisations was published for comments in December 2014 along with revised capital framework for securitisations.

Early Regulation of Securitisation in India

12. There is no comprehensive single regulatory framework for the securitisation market per se. In effect, only the financial sector has a clear framework for participating in securitisation.

13. The recommendations of the High Level Committee on Corporate Debt and Securitisation (Chairman:

Dr.R.H.Patil) in 2005 proved to be the turning point towards the development of the corporate debt and securitisation market.

14. The Reserve Bank accepted several of its recommendations and in February 2006, issued guidelines for securitisation of standard assets by Banks, FIs and NBFCs. These guidelines provided the regulatory framework for several critical aspects of securitisation.

15. In 2007, the Securities Contracts (Regulation) Act 1956 was amended in 2007 to include “securitised instruments” in the definition of “securities”. The amendment has paved the way for listing and trading of securitised debt on stock exchanges.

16. Consequently, the Securities and Exchange Board of India (SEBI) released draft regulations for “Public Offer and Listing of Securitised Debt Instruments” in June 2007 which is yet to be formalised. However, these guidelines envisage a very different transaction structure compared to current market practices.

17. Earlier, the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 (SARFAESI Act 2002) enabled securitisation of the non-performing assets of Banks, which could sell off their NPAs to asset reconstruction companies registered with RBI. The SARFAESI Act also laid the framework to the constitution of asset reconstruction companies (ARCs) specialising in securitising distressed assets purchased from banks.

Role of the Reserve Bank of India in regulation of Securitisation

18. The Reserve Bank of India (RBI) is the regulator of the major players in the Indian financial system (banks, financial institutions and NBFCs) and has to ensure that financial intermediaries engage in Securitisation prudently.

19. The Reserve Bank issued the first set of comprehensive guidelines applicable to banks, financial institutions and non-banking financial companies (NBFCs) on Securitisation in India way back in February 2006. The

guidelines covered following aspects relating to Securitisation transactions:

- Broad definitions on important securitisation related concepts such as securitisation, SPV, bankruptcy remote, credit enhancement, first loss facility, liquidity facilities, service provider and underwriting facilities.
- Prescribed detailed 'true sale' criteria and criteria to be met by originators and SPVs. Some important criteria included that originators should not indulge in market making on securities issued by SPV, originators shall not invest in more than 10% of securities issued by SPV, securities cannot have any put option, etc.
- Detailed policy for originators and third parties on provision of credit enhancements, liquidity support/ facilities, underwriting facilities, servicing arrangements, etc.
- Capital adequacy norms for Credit Enhancement - First loss credit enhancement is deducted from

capital and second loss facility is risk weighted according to the rating. Credit enhancement cannot be withdrawn/ reduced by the provider throughout the life of the transaction except to cover the losses suffered by SPV.

- Prudential Norms for investment in the securities issued by SPVs.
- Accounting treatment for securitisation transactions - An important feature was that profit / premium arising on account of sale should be amortised over the life of the securities issued or to be issued by the SPV.
- Due diligence framework for securitisation transactions and disclosures to be made by the SPVs/ Trustee and originators.

20. Based on the lessons learnt from the global financial crisis on Securitisation and with a view to develop an orderly and healthy securitisation market, the RBI guidelines of February 2006 were reviewed and

enhancements to the guidelines issued in May 2012. While the securitisation framework in India had been reasonably prudent, certain imprudent practices had reportedly developed like origination of loans with the sole intention of immediate securitisation and securitisation of tranches of project loans even before the total disbursement was complete, thereby passing on the project implementation risk to investors. In view of the same and in accordance with the on-going international work on Securitisation, another important objective of the enhancements was to ensure greater alignment of the interests of the originators and investors and retention of 'skin in the game' by the originators. These guidelines also covered prudential treatment for transfer of assets through direct assignment of cash flows and underlying securities, if any. The important features of the May 2012 guidelines are as follows:

- Prescription of the Minimum Holding Period (MHP): Minimum Holding Period varies from 3 months to 12 months depending upon the tenor of the loan and repayment frequency and is defined in terms of

number of installments paid. The criteria governing determination of MHP reflect the need to ensure that i) the project implementation risk is not passed on to the investors and ii) a minimum recovery performance is demonstrated prior to securitisation to ensure better underwriting standards.

- Prescription of Minimum Retention Requirement (MRR) – 5 % for loans up to 24 months and 10% for loans of tenor beyond 24 months. The MRR is primarily designed to ensure that the originating banks have a continuing stake in the performance of securitised assets so as to ensure that they carry out proper due diligence of loans to be securitised.
- 'True sale criteria' made applicable to assignment transactions also.
- Liberalised recognition of cash profit received allowed in view of the mitigation of concerns on 'Originate to Distribute' models.
- Disclosures requirements were strengthened and due diligence expectations were elaborated.

- Stress testing requirements were laid for banks/FIs/ NBFCs in respect of their Securitisation positions. The factors for stress tests could include rise in default rates in the underlying portfolios in a situation of economic downturn, rise in pre-payment rates due to fall in rate of interest or rise in income levels of the borrowers leading to early redemption of exposures, fall in rating of the credit enhancers resulting in fall in market value of securities (Asset Backed Securities/ Mortgage Backed Securities) and drying of liquidity of the securities resulting in higher prudent valuation adjustments, etc.
- Outsourcing of credit decision is not allowed.
- In case of non-compliance with the guidelines, as applicable to originators, no capital relief will be available for originators. For investors, in case of non-compliance with guidelines as applicable to investors, the asset will be risk weighted at 1111% (revised to 1250% in March 2015).

- Certain forms of Securitisation transactions / structures are not allowed - Complex structures such as Re-Securitisation and Synthetic Securitisation is not allowed. Revolving credit facilities cannot be securitized / assigned. Single asset Securitisation are not allowed – as they do not fit into the definition of Securitisation. Securitisation / assignment of loans where both interest and principal are due only at maturity are not allowed – as it is not possible to assess the repayment track record.
- Credit enhancement is not allowed in case of assignment transactions – as the assignment deals are generally carried out among two financial institutions. It is expected that the purchasing institution will do its own due diligence while acquiring assets rather than relying on credit enhancement.

Indian Securitisation market and transaction volumes

21. The Indian market is still at a nascent stage driven as it is by the needs for meeting priority sector lending targets

by banks. The band of originators and investors is narrow with NBFCs as the main originators and banks as investors. Public Sector Banks are mostly absent. Asset backed securitisation (ABS) is the largest securitisation class in India, driven by retail loan portfolio of banks. NBFCs like the Asset Finance Companies (AFC) operating in the SME and Transport financing segments and Micro Finance Institutions (MFI) are very active as originators. Though the market had begun since the year 2000, the GFC obviously has its repercussions in Indian market as well. It is reported that the Indian Securitisation market which reached a high of ₹ 63,730 crore by March 2008 dwindled down to ₹ 28,800 crore in by March 2014.

22. The micro finance companies play a larger role mainly due to their PSL underlying pools. Another positive development witnessed in recent years is the preference for multiple tranche products as against single tranche structures. Another encouraging factor is the preference for the lower rated senior tranches by the investors. It is

reported that during the financial year 2014, the number of AAA ratings at initiation dropped from 45% in 2012 to 26%.

23. Insurance, Pension and Mutual Funds can play an important role in the Indian securitisation market as they can invest long term and at the same time have the risk appetite, capacity and expertise for taking exposures to the lower tranches. However, the Pension Funds are not allowed to invest in securitisation PTCs and Insurance companies are allowed to invest in high investment grade AAA securities only. MFs are still hesitant to invest in the securitised papers due to past pending court cases as well as lack of clarity on the tax implications for their investments. In the Finance Bill 2013, Mutual Funds were exempted from application of the Distribution Tax imposed on securitisation SPV's.

Low Appetite for Securitisation in Indian financial market

24. The appetite for Securitisation in India has been on the lower side; it is used largely to meet priority sector lending targets by banks as investors, NBFCs being the

originators. This low appetite can be ascribed to several factors, including legal, taxation and stamp duty issues.

25. Recently, we undertook an informal and quick survey of the securitisation market in India. The primary objective was to assess the issues facing the market along with the reasons for poor take off in securitisation as a risk transfer and liquidity enhancing product. The sample survey included originators, investors, third party liquidity and credit enhancement providers, servicers and arrangers, SPVs / trustees, credit rating agencies, etc. The major issues highlighted by the participants related to disclosures, low demand for Long Tenor Receivables, lack of Investor base, absence of Secondary market besides the Taxation, Stamp Duty and Legal aspects including Foreclosure Laws.

The way forward – Ambling Down or Revving Up

26. Though significant progress has been made in reconfiguring Securitisation markets in the aftermath of the global financial crisis, the task of ensuring that these

markets contribute to economic growth and financial stability is unfinished.

27. In this context, we must note that fingers are pointed at the regulatory framework itself. It is alleged that the regulations are conservative, and inhibit the growth of the segment. The restrictions on assignments, the prohibition of re-securitisation, the restrictions on the insurance and pension funds, the restrictive first-loss provisions, the restrictive credit enhancement provisions etc. are mentioned as impediments. With tax related disincentives driving away investors like Mutual funds, and even banks, the critics say the Indian Securitisation market can only be ambling forward.

28. I beg to differ. In my opinion, the Indian Securitisation Market is raring to go. Let me explain.

29. Firstly, the priority sector obligations will continue to be a good reason for securitisation. While the upcoming Priority Sector Lending Certificates (PSLC) can kind of dent the market, there will still be need for diversification of

portfolios and hence the Securitisation will still have its place.

30. Secondly, the NBFCs, be they Asset Finance Companies specialising in SME financing or transport financing, or be they MFIs or Housing Finance Companies (HFC), their USP is their capacity to originate loans and advances in sectors where the main stream banks have least penetration. They have comparative advantage and to leverage that they will have good opportunities in resorting to Securitisation.

31. Thirdly, the new set of differentiated banks, the Small Finance Banks, whose major portfolio will be small loans, will resort to securitisation for diversifying their balance sheet. In all likelihood, they are unlikely to build capacity in large sized lending and will resort to build diversified portfolio of large credit through Securitisation.

32. Fourthly, given recent experience relating to the stress and non-performance of infrastructure finance and project finance, questions have been raised about the

capacity of other than large banks in the credit appraisal of such large credits. This can compel these banks to participate in large infrastructure and project credits through Securitisation *after* the project has taken off, rather than participating through consortium or multiple banking arrangement *before* the cash flows have emanated.

33. For these to happen, there is a need for a change in the mind set and attitude of banks and financial institutions, including the NBFCs.

34. These institutions should reflect on the following questions:

- Are we good in originating or holding?
- Do we have deep pockets?
- Do we find value in continuous turning over, or in holding on without growth?
- For diversification, do we build our entire portfolio or acquire a part?
- Should we build capacity in all segments of credit or focus on the best suited?

35. They also need to be ready to let go. Primarily, they should be prepared to parcel out high quality cash flows and share the spoils of good cash flows.

36. We as regulators are ever ready to assist financial market development. As I understand, initiatives are underway by SEBI to formulate a detailed template mandating disclosure requirements covering granular details of all aspects of securitisation transactions / products. Similarly, SEBI is further examining the prospects of setting up a trading and reporting platform where all securitisation transactions will be reported and a central data repository will be available to the securitisation market participants. IRDA and PFRDA have been requested to look into their rules and regulations to facilitate long term investments by Insurance and Pension funds in securitised products. Reserve Bank will also review the guidelines on an ongoing basis.

37. Thank you all for your patient attention.

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