Chapter 5 Impediments to Securitisation

5.1 General

5.1.1 The ideal conditions for success of securitisation in USA and other countries are important to understand in order to explore business opportunity in EMs. Securitisation owes its existence, in part, to the need for housing finance in USA after the Great Depression. Congress in USA established the Federal Housing Administration in 1934 to provide Government guarantee on certain mortgages. This was followed by the creation of Federal National Mortgage Association (Fannie Mae) as the first Government agency to provide a market in Government guaranteed mortgages. In 1970, in response to increasing housing trend, the Government National Mortgage Association (Ginnie Mae) began to guarantee timely payment of principal and interest on pass-through securities issued by private mortgage Originators and backed by pools of Government-insurers on guarantee mortgages.

Government related agencies continued their activities to encourage development of a secondary market through 1970s and 1980s. They introduced a variety of programmes and securities to attract new investors to the secondary market. The Secondary Mortgage Market Enhancement Act (SMMEA) was passed in 1985 to enable private issuers of securities to compete more effectively with Government-related agencies by removing some of the legal impediments. This included i) permission to banks to invest in privately issued mortgage-related securities & ii) permission for delayed deliveries of such securities thereby allowing a forward trading market to develop. An active secondary market permitted traditional mortgage lenders to liquidate their loans by selling them through Government related agencies or securitising them in the form of MBS. By 1992, pass-through market was comparable to the corporate market size and was substantially larger than the agency market. collateralised mortgage obligation (CMO) securities introduced various tranches with various risk and return characteristics.

The details of development of securitisation in USA, Europe, Australia, Japan, Argentina, Morocco, etc. are given in Chapter 6.

5.1.2 The environment for securitisation in EMs is different from that in the developed markets for various reasons which include (i) Narrow investor base; (ii) Cultural factors; (iii) Poor capital market infrastructure; (iv) Regulatory environment; (v) Legal hurdles; (vi) Lack of proper accounting standards; (vii) Taxation burden; (viii) Poor quality of assets; (ix) System deficiencies and (x) Lack of standardisation. These are discussed in the following paragraphs.

5.2 Investor base

There is no market without buyers. They may be domestic or foreigners; individuals or institutions – financial or non-financial, regulated or non-regulated; sovereign or non-sovereign. Investors look for (i) Asset performance - Lack of historical or meaningful performance data may make it difficult to predict performance; (ii) Third party performance-Reliance on asset servicers, credit support providers etc.; (iii) Currency exposure and the availability of swap opportunities at reasonable cost; and (iv) Secondary market liquidity. The perceived risks are reflected in pricing in case securitisation actually takes off. Investors also look towards the services of the independent rating agencies to get confidence. An underdeveloped secondary market for securitised assets that lacks liquidity is an obvious problem to an FI in EM that is attempting to find investor acceptance. In India, the following issues need further clarifications:

- The status of ‘Pass Through Certificates’ as ‘Securities’ under the SCRA is not clear;

- Investment in securitised paper (whether as PTCs or debt instruments) needs to be specifically permitted for FIs;
- The risk weightage norms for these instruments are not defined. The NPA norms as applicable to securitised debt also need to be clarified;
- Adequate disclosures about the assets need to be made to facilitate the investor to make his/her view on the security.

5.3 Cultural factors

In many EMs, decisions for loans are 'compromised' decisions rather than 'rational' decisions. The process generates loans which are less homogeneous and are not of high quality. Further, nature of 'participation certificates' as distinct from traditional securities such as shares and debentures needs to be recognised. In practice, the FIs as investors look forward to security in the form of creation of charge over physical assets. The mindset against unsecured investments has to undergo a significant change to accept financial claims in the case of securitisation of future flows as collateral.

5.4 Capital Market Infrastructure

Debt markets are at their infancy in many of the EMs due to the underdevelopment of institutions and the instruments.

Further,

- Foreclosure norms need to be simplified to facilitate speedy recovery;
- Securitised paper is not specifically included in proposed notification exempting stamp duty on transfer of debt instruments in the depository mode. This would act as a negative feature vis-à-vis standard debt instruments;
- The market requires the emergence of back-up servicers to protect against any negligence by the Originator (as Administrator)

5.5 Regulatory environment

The regulations in a country for capital adequacy requirements are important motivators for the Originators to undertake securitisation. Clear guidelines for the treatment of true sale and off balance-sheet items can pave the way for securitisation. Further, many financial experts believe that by diminishing the pivotal role of FIs in financial intermediation, securitisation lessens the effectiveness of monetary policy. FIs and regulators in many countries are concerned that the weakening of close ties between FIs and their corporate customers may undermine not only traditional patterns of financial intermediation, but patterns of corporate governance as well. In the Indian scenario, the following issues need further attention:

(a) The guidelines for investments by insurance companies need to be clarified for investments in securitised instruments;
(b) Mutual funds are not permitted to invest in MBS;
(c) The application of current NBFC norms to the Special Purpose Vehicle will render the entire process inefficient.

5.6 Legal provisions

Securitisation is a legal intensive transaction. Different laws apply to different classes of assets. Since all legal provisions connected to securitisation are not consolidated under a single statute, the task of developing a set of sound documents becomes much more tedious.

The legal issues in India (including recommendations) are discussed in detail in Chapter 9, which include:

-The Stamp duty on assignment of receivables is not uniform across states and also too high in most states rendering securitisation unviable. While some State Governments have reacted positively by reducing stamp duty on assignment of assets for the purpose of securitisation, resistance has been met with in other States because of the loss of revenue;

-Compulsory registration on transfer of assets involves registration fees, which adds to the cost of securitisation;

Absence of clear legal provisions on

- Partial assignment of assets
- Assignment of future receivables

5.7 Accounting

5.7.1 If the Originator provides credit enhancements in the form of a limited guarantee or pool substitution to a certain extent, there is said to be some recourse back to the Originator. In the absence of clear accounting guidelines, accountants find it difficult to classify such transactions as a sale treatment.

5.7.2 In case of financial intermediaries securitising their assets, the treatment of the overcollateralised assets in their books needs clarity.

5.7.3 Accounting for securitisation transactions is not clear on

- De-recognition of assets from books of Originator
- Treatment for pass through certificates and the securitised assets in the books of the SPV where the pass through structure is adopted
- Assignment of future receivables and income recognition for the same in the books of the Originator

5.8 Taxation

In order to encourage securitisation, SPV needs to be tax neutral. Other impediments include:

- Transfer of income without transfer of underlying assets still makes Originator liable for taxation;
- It is not clear whether HFCs can continue to issue certificates to borrowers to claim income tax benefits under Sections 24(1)(vi) and 88, after the receivables have been assigned;

Taxation of parties involved in securitisation is not clear, for example

* Capital gains implications on assignment of receivables by the Originator to the SPV
* Possibility of entity taxation of SPV
* TDS on passing on of cashflows by SPV to the investors

5.9 Quality of assets

The Originators need to have a minimum viable amount of quality assets to make the securitisation transaction attractive in view of some minimum expenses to be incurred for fees for structurer, rating agencies, lawyers, auditors, road shows, etc.

5.10 System Deficiencies

The following system deficiencies have been identified in the Indian financial system:

- Securitisation requires the Originator to have an efficient information capturing and delivery system. Due to the heavy capital cost involved, both individual Originators and the Indian financial system as a whole are not geared to meet these requirements;
- Information on historical data is generally not available;
- Very little information is available on the demographic characteristics of potential asset pools (such as auto loans, individual housing loans, credit card dues, etc) that are amenable to securitisation;
- Credit information on Originators and potential Originators is also not readily available. Participation from credit bureaus in the process of securitisation is required.

5.11 Standardisation

This refers to FIs and other lenders adopting common formats, practices and procedures in loan origination, documentation, application and administration (servicing).

Th Indian financial system is presently characterised by a lack of standardisation in all aspects of the *loan origination* with the exception of Government sponsored loans or housing loans granted by some of the large housing finance institutions. Each bank or institution uses its own form of contract. Standardisation of a particular category of loan will facilitate securitisation of these loans.

Standardisation does not necessarily mean that all lenders must extend credit using the same criteria or on the same terms but rather that certain fundamental aspects of the lending process are standardised among lenders. For instance, lenders may adopt *a standard form of mortgage loan agreement* that provides adequate legal protection to all lenders. It ensures that investors in a pool of loans (or the rating agencies) do not have to analyse the risk of several different legal documents.

Lenders may also agree to use loan *applications* that request the same information from borrowers. This does not mean that each lender must grant credits on the same criteria but that each lender is obtaining the same basic information from the borrowers making it easier for investors to compare loans originated by different lenders. If applications ask different questions, it is more difficult for investors to evaluate loans originated by one lender against loans originated by another lender.

Standardisation of *servicing* typically involves the standardisation of the type of information that is monitored (i.e. balance, payment history, address, etc.). In addition, there can be standardisation of the documents and information that are maintained in each loan file. There can be standardised data processing systems and software. It can also facilitate a new servicer to take servicing, if required.

These impediments may have to be addressed by the Indian financial community in a phased manner in order to make the securitisation successful in the Indian financial system.