RESEARCH PAPER | Management | Volume : 3 | Issue : 9 | Sept 2013 | ISSN - 2249-555X

Securitization in India: A Bumpy Ride

KEYWORDS Securitization, Originator, Special Purpose Vehicle

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ABSTRACT *Securitization has emerged globally as an important technique for bundling assets and segregating risks into marketable securities. Securitization, an innovative invention of the 1970s from the western world, has had a bumpy ride in Indian capital markets since its inception. From first legal framework in 2002 to RBI's draft guidelines in early 2006, from sub-prime mortgage crisis to RBI's final guidelines of 2012, Indian securitization market has never been stable. Securitized assets include mortgages (residential as well as commercial), credit card receivables, auto loans and other forms of debt obligations and receivables. This paper will discuss several aspects of Indian securitization market, elaborating the process, discussing the fluctuating performance in response to global events and significant changes in regulations.*

Introduction

Securitization is the process through which an issuer pools several types of financial assets and sells the repackaged instruments to Investors. The repackaged instruments can be Bonds, Pass Through Certificates (PTCs), Collateralized Mortgage Obligations (CMOs) consolidated through the pooling of contractual debt such as mortgages (residential and commercial), auto loans and credit card debt obligations. Securities which are backed by mortgages are known as Mortgage Backed Securities (MBS) while the ones backed by other types of receivables are known as Asset Backed Securities (ABS). Other instruments used are Collateralized Debt Obligations (CDOs) and Loan Sell Off (LSO) issuances.

History of Securitization

Securitization in its present form originated in mortgage markets of USA in 1970. Government promoted the secondary markets in mortgages to promote liquidity for mortgage finance companies. In India, first securitization deal dates back to 1990 when Citibank secured auto loans and sold to the GIC Mutual Fund. Securitization markets began to grow post the globalization and integration of capital markets in India when financial players in India adopted innovative strategies to promote liquidity in the then illiquid mortgage markets. First legal framework for securitization in India was not drafted until 2002 when Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act was promulgated. According to this Act, securitization was defined as "acquisition of financial assets by any securitization company or reconstruction company from any originator, whether by raising funds by such securitization or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial assets or otherwise". The notion of financial assets for the above definition is stated as any debt or receivables. "Secured Creditor" means any bank or financial institution or any consortium or group of banks or financial institutions and includes—

(i) Debenture trustee appointed by any bank or financial institution; or
(ii) Securitization company or reconstruction company, whether acting as such or managing a trust set up by such securitization company or reconstruction company for the securitization or reconstruction, as the case may be; or
(iii) Any other trustee holding securities on behalf of a bank or financial Institution

Process of Securitization

The primary players in the securitization of any particular pool of assets can vary. Each player is addressed below:

1. **Originators** – the parties, such as mortgage lenders and banks, that initially create the assets to be securitized.
2. **Aggregator** – purchases assets of a similar type from one or more originators to form the pool of assets to be securitized.
3. **Depositor** – creates the Special Purpose Vehicle for the securitized transaction. The depositor acquires the pooled assets from the aggregator and in turn deposits them into the Special Purpose Vehicle (SPV).
4. **Issuer** – acquires the pooled assets and issues the certificates to eventually be sold to the investors. However, the issuer does not directly offer the certificates for sale to the investors. Instead, the issuer conveys the certificate to the depositor in exchange for the pooled assets. In simplified forms of securitization, the issuer is the Special Purpose Vehicle which finally holds the pooled assets and acts as a conduit for the cash flows of the pooled assets.
5. **Underwriter** – usually an investment bank, purchases all of the SPV's certificates from the depositor with the responsibility of offering to them for sale to the ultimate Investors. The money paid by the underwriter to the depositor is then transferred from the depositor to the aggregator to the originator as the purchase price for the pooled assets.
6. **Investors –** purchase the Special Purpose Vehicle's issued certificates. Each investor is entitled to receive monthly payments of principal and interest from the Special Purpose Vehicle. The Special Purpose Vehicle makes distributions to the investors from the cash flows of the pooled assets.
7. **Trustee –** the party appointed to oversee the issuing Special Purpose Vehicle and protect the investors' interests by calculating the cash flows from the pooled assets and by remitting the SPV's net revenues to the Investors as returns.
8. **Servicer –** the party that collects the money due from the borrowers under each individual loan in the asset pool. The servicer remits the collected funds to the Trustee for distribution to the investors. Servicers are entitled to collect fees for servicing the pooled loans.
9. **Credit Enhancers** - possibly a bank, surety company, or insurer, who provides credit support through a letter of credit, guarantee, or other assurance.
10. **Rating Agency –** the party that assesses credit quality of certain types of instruments and assigns a credit rating.

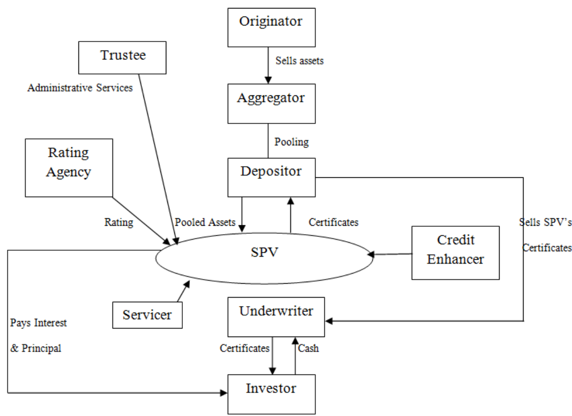

Figure - 1 : Process and players of securitization

Growth of Securitization in India

1. FY02-FY05

SARFAESI Act provided the framework to the constitution of asset reconstruction companies specializing in securitizing assets purchased from banks. Through the 90s, securitization of auto loans was the mainstay of the Indian markets. But since 2000, Mortgage Backed Securities (RMBS) have fuelled the growth of the market. Post SARFAESI Act, the securitization market in India matured significantly with the established band of investor community and regular issuers. Since the inception, securitization volumes have been scaling peaks every year. The party continued till 2005. Innovative transactions with prepayment protected tranches, etc kept on emerging in the market. This growth was due to investors' familiarity with the underlying asset classes, relatively shorter tenures of issuances, stability in the performance of past pools.

Type	FY02	FY03	FY04	FY05
ABS	12.9	36.4	80.9	222.9
MBS	0.8	14.8	29.6	33.4
CDO/LSO	19.1	24.3	28.3	25.8
Others	4.0	2.3	0.5	26
Total	36.8	77.8	139.3	308.1

Table-1 : Trend in Securitization volume during FY02-FY05 (Rs. Billion)

2. FY06-FY11

In early 2006, the RBI came out with guidelines on regulatory capital treatment for securitization which dealt a blow to the securitization market. The RBI guidelines provided a robust regulatory and institutional framework for the orderly development of the securitization market in the long term. At the same time the guidelines eliminated some incentives for securitization. This led to temporary reduction in issuance volume. However, in the medium and long term, the securitization market witnessed reasonable growth. There were several changes that occurred in response to these guidelines. The first change is that several originators shifted from a securitization structure to what is termed as "direct assignment" structure. A direct assignment is a bilateral portfolio sale – there is no Special Purpose Vehicle here as the buyer is an operating company or investor. In view of the language of the RBI Guidelines, it was felt that these transactions will not be covered by the RBI guidelines, which explicitly define securitization to mean transfer of assets to SPVs. The second perceptible change is that in several deals, instead of credit enhancements provided by the originator, there is a "third party guarantee", typically from a bank. A bank guarantee is also a first loss support provided by the bank, and the capital consequences that typically arise to the originator will arise to the bank in such cases. It would be difficult to contend that such guarantee is a mezzanine support, unless the mezzanine piece has been given an investment grade rating. After a decline in FY06, the markets grew significantly till FY08. Until the first half of FY09, the Indian structured finance market was not severely impacted by the global credit crisis, largely because of the absence of transactions involving complex derivatives, revolving structures, and credit default swaps. Low structural complexity and leverage levels relative to that in typical transactions in developed markets, as well as the fairly stable performance of the underlying assets, insulated Indian investors from the widespread multi-notch downgrades of structured finance papers that happened overseas. However, the tight liquidity conditions during the third quarter of FY09 led to significant redemption pressure on Mutual Funds. In that scenario, the relative illiquidity and lack of market depth for structured finance paper made their impact felt. This, along with rising concern over the underlying credit quality, caused investor interest in structured paper to decline. On the other hand, during the second half of the fiscal year, loan originators started to lend more cautiously due to tight liquidity conditions and increase in the interest rates. With a slowdown in the growth of their loan books, the originators' need to securitize loans (to raise resources) also declined. The dip in the overall securitization volumes in FY10-FY11 owed mainly to the substantial reduction in LSO issuances. The recommendations of RBI regarding the minimum lock-in period and minimum retention requirement, affected corporate loan sell-down transactions, which were mostly short-term in nature.

Type	FY06	FY07	FY08	FY09	FY10	FY11
ABS	178.5	234.2	313.2	135.8	209.7	218.1
MBS	50.1	16.1	5.9	32.9	62.5	50.2
CDO/LSO	21.0	119.0	318.2	364.4	145.8	44.4
Others	-	-	13	11.6	7.9	5.4
Total	249.6	369.3	650.3	544.7	425.9	317.1

Table-2 : Trend in Securitization volume during FY06-FY11 (Rs. Billion)

3. FY12-FY13

Issuance volume in the Indian securitization market was Rs. 366.1 billions in FY12, a growth of 15% over the previous fiscal. The increase in volume following a continuous decline for three years was on account of a 26% rise in securitization of retail loans (both ABS and MBS cumulatively). The number of transactions was also 32% higher in FY12 than in the previous fiscal. The number and volume of retail loan securitization (both ABS and MBS together), was the highest in FY12 compared to previous fiscals, while the LSO issuance was the lowest ever. RBI's draft guidelines issued in the first quarter of FY2011, specially the requirement of Minimum Holding Period (MHP) of 9 to 12 months, created a potential interest rate risk for the originator and adversely affected the LSO issuance volume. Moreover, the lackluster demand from mutual funds (MFs)—the key investor segment in LSOs in the past—owing to low secondary market liquidity for PTCs, and the prohibition on investment by liquid funds in debt with tenure longer than 91 days further impacted LSO issuance volume. As per the 'Master Circular by the RBI for Lending to Priority Sector' released in July 2011, loans by banks to Non Banking Financial Companies (NBFCs) no longer qualify as Priority Sector Lending (PSL); post this change in regulation there was only one major way in which banks could meet their shortfall in priority sector lending targets, viz., acquisition of compliant portfolios from NBFCs. On the other hand, originators' (read NBFCs') motive in entering into these transactions was a finer pricing, capital relief and tenure-matched funding, apart from keeping open an alternate fund-raising channel. This led to a rise in transactions involving bilateral assignment of retail loan pools.

The RBI Guidelines on Securitization and Direct Assignment issued in May 2012 for banks and in August 2012 for NBFCs prohibited originators from providing credit enhancement for assignment transactions. Pursuant to this move by RBI, there

Volume : 3 | Issue : 9 | Sept 2013 | ISSN - 2249-555X

was a significant shift from the assignment route (assignment of receivables directly by the originator to the purchaser, with credit enhancement) to the conventional securitization route (assignment of receivables by the originator to an SPV, issue of Pass-Through Certificates (PTCs), with credit enhancement)

Type	FY12	FY13
ABS	260.7	266.3
MBS	76.8	36.2
CDO/LSO	22.2	-
Others	6.4	-
Total	366.1	302.5

Table-3 : Trend in Securitization volume during FY12-FY13 (Rs. Billion)

4. Future Expectations

Going forward, ICRA expects the market dynamics to alter again following the clarity in the taxation regime for securitization, brought in by the Union Budget 2013-14. The new tax treatment should open the path for mutual funds to invest in securitization transactions. Nevertheless, the same is feared to be a negative for banks, since there could be a proportionate disallowance of expenses incurred in respect of such investment—thus having a significant impact on the post-tax yield on the transactions. Consequently, 2013-14 could witness a return of direct assignments as the chosen route for acquiring PSL assets by banks, new transaction structures in securitization to minimize the taxation impact and MFs restarting investments in securitization. The issuance of final guidelines on reset of credit enhancement in securitization transactions (likely to be issued by the RBI by end-June 2013) is expected to be another important development in the securitization space. Reset of credit enhancement should help in lowering the charge on capital and thus, improving the economics of a securitization transaction.

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