Shyamala Gopinath: Securitisation markets in India – a post-crisis perspective

Inaugural address by Ms Shyamala Gopinath, Deputy Governor of the Bank of India, at the India Securitisation Summit 2010 hosted by the National Institute of Securities Markets (NISM), Mumbai, 10 August 2010.

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1. It is my pleasure to be delivering the inaugural address at this Securitisation Summit. I am thankful to the NSIM, particularly Mr. Sethu whose persistent efforts brought me here today. The development of a robust securitisation market in India, along with a broader corporate bond market, though universally acknowledged as a desired objective is proving a challenge in reality. In my address today I wish to touch upon some of the issues engaging the policy deliberations, particularly in the post-crisis context.

2. It has become customary these days for any speech on financial sector to start from the vantage point of the crisis – it is such an inflexion point. Howsoever hard one tries, it becomes well nigh impossible to disassociate from the immediacy of the crisis, particularly when talking about a market so intricately linked to the crisis – securitisation.

3. Securitisation generically refers to the pooling of cash-flow-producing assets (e.g., mortgages, loans, bonds) and subsequent issuance of securities in the capital markets backed by these collateral pools. This broad definition encompasses simple non-tranched structures, including covered bonds and pass through structures as well as tranched water-fall structures. The latter is a recent phenomenon and it is this version which accentuated the crisis.

4. Structural benefits from securitization arise from the flexibility they provide in transforming cash flows and risks of the collateral pool into those of the securities issued on the pool. The traditional vanilla securitisation models have played an important role in strengthening the lending culture by providing the lenders with an avenue to free up the balance sheets in a cost-effective manner. Securitization can also improve balance sheet liquidity by converting long-term and illiquid receivables into funds that can be used for additional value-generating investments. Furthermore, securitisation enables end investors to obtain a more efficient market portfolio and thereby diversify their idiosyncratic risks.

5. However, the growing complexity over the years dissociated securitisation from its key positive attributes. The role that market failures in securitisation, particularly securitisations of US subprime mortgages, played in precipitating the financial crisis has been widely acknowledged. The analysis has thrown up various factors but the fundamental problem with the way securitisation markets developed in recent years was the inadequate understanding and pricing of risks inherent in the process of transformation of risks – credit risk transformation, liquidity transformation and maturity transformation. It was expected that the process of securitisation was undertaking a socially value-enhancing inter-temporal and inter-participant risk transfers through the capital markets. However, there were serious deficiencies in this process, as became evident during the crisis, the most glaring of which were that (i) task of risk management got disowned and (ii) risks ultimately remained on the bank balance sheets.

- The “originate and distribute” approach implied a clear incentive against prudent credit appraisal standards as the traditional risk management of the loan portfolio through sound monitoring and analysis was found to entail significant, avoidable costs. The focus shifted decisively from “managing the risks” to “disowning the risks” as soon as possible.

- The growing complexity and lengthening of the chain involving multiple intermediaries resulted in increased distance from the originator. The longer chain gave rise to several principal/agent problems.
- The maturity transformations, effected through the SIV model, placed predominant reliance on indirect bank support to short term collateralised markets for funding long term exposures. This militated against the very concept of de-risking the bank balance sheets.
- There were fundamental modelling issues which resulted in incorrect estimation of riskiness and default correlations of the underlying assets. The problem of adverse incentives induced by incorrect modelling issues was further exacerbated by the legitimacy accorded to the same by rating agencies and the regulatory framework.

6. The repair work is underway and the efforts are directed at designing a framework for "sustainable securitisation". These include BCBS measures adopted in July 2009 to strengthen the capital treatment of securitisation and establish clear rules for banks' management and Pillar 3 disclosure. These actions address the regulatory arbitrage incentives that led to distortions in the market, and at the same time will drive changes in transaction structures and incentives going forward. Accounting standards are being strengthened to ensure disclosure of off balance sheet entities and tighten derecognition requirements.

7. Other proposals being considered internationally include a requirements for the originators to retain a portion of each securitization originated and a minimum period of retention of loans prior to securitization to give comfort to ensure adequate due diligence by the originator.

Indian securitisation market

8. The growth in the Indian securitisation 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 securitisation (ABS) is the largest securitisation class driven by the growing retail loan portfolio of banks, investors' familiarity with the underlying assets and the short maturity of these loans.

9. Though securitisation 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 securitised. 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 securitisation has been attempted in the past include property rental receivables, power receivables, telecom receivables, lease receivables and medical equipment loan receivables.

10. 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.

11. In the recent times, direct assignment of single loan or retail loan pools (as against securitisation 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.

12. The choice of the route, “direct assignment” or “securitisation” depends largely on investor preference and such deals are customised 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.

13. 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.

Recent trends

14. Though the securitisation market in India is marked by relatively simple structures and stable ratings, concerns over asset quality have affected investor appetite for securitisation in the post-crisis scenario. Much of the securitisation 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 r banks to meet priority sector lending targets. Most of the securities are acquired with the intention to hold to maturity.

15. As per the data compiled by major rating agencies, the year 2009–10 has witnessed an overall moderation in the volumes in securitisation market. Total issuance volume saw a decline of 22% in 2009–10 over the previous fiscal. The dip in the overall securitisation 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 securitise – as a funding source – was limited. Nevertheless, securitisation of retail loans, both ABS and RMBS reported a 61 per cent increase in volume in 2009–10.

16. While the securitisation 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.

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.

RBI guidelines

17. 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.

18. Another feature of the 2006 guidelines was the requirement that the gain on securitization of assets should not be recognized upfront and should be amortised over the life of the securities issued. This requirement was put as a conservative measure to avoid securitisation being used to inflate profits even while banks exposures in various capacities to the SPV remain.

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

20. 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.

21. The guidelines further stipulate that the total exposure of banks to the SPV and/or securitised 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-collateralisation and liquidity support should not exceed 20 percent. Complex securitisation structures viz. re-securitisation, synthetic securitisations and securitisation with revolving structures are specifically prohibited.

22. Similar guidelines have also been issued in respect of securitisation transactions undertaken by NBFCs.

23. 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-tranched" issuances as against "credit tranched" issuances

f. Relaxation in respect of the "total exposure" norm

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

Conclusion

25. Globally, over the past two decades, banks have lost their traditional role as the dominant suppliers of credit in some countries, and securitisation 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, securitisation 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 securitisation market have come to the fore. Securitisation per se has not been discredited totally though the new normal for securitisation markets is expected to be lower than its pre-crisis peak.

26. 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.

27. The downside of securitisation 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 securitised. Any restructuring requires consent of the final investors and in the long chain of intermediaries it becomes difficult to restructure debt.

28. 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.

29. In the Indian context, "sustainable securitisation" 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 securitisation market develops for the right reasons. It is also necessary to promote standardisation 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 securitisation should be subject to the guidelines on securitisation.
- Though securitised paper issued by securitisation SPVs has been recognised 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 securitisation, particularly mortgage related securitisation, 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.

30. I am sure the deliberations today will cover some of these issues and come up with viable suggestions.