Securitisation of standard assets in domestic market: Regulatory initiative and way forward

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Preamble

The primary aim of securitization market is redistribution of credit risk away from the originators to a wide spectrum of investors who understand the risk and can bear the risk, thus aiding financial stability and provide an additional source of funding.

The securitization market has evolved gradually over the last decade, although the growth has been mostly in retail asset backed and mortgaged backed securities. As per CRISIL estimate, there is a five-fold increase in market size from INR 40,000 Cr in FY 2013 to INR 192,000 Cr in FY 2019. Retail asset backed securities have increase from INR 30,000 Cr to 99,000 Cr whereas Retail Mortgage backed securities have increased from INR 10,000 Cr to INR 90,000 Cr.

Risk and Rewards for Bank

Banks that securitise their assets stand to reap measured benefits such as reduced capital requirement, better balance sheet ratios, refinancing at lower cost, reduction in credit concentration risks as originator and are also able to diversify their portfolios by acquiring different asset types from different geographic areas as investors.

Since securitisation unbundles the traditional lending function into several roles, such as originator, servicer, sponsor, credit enhancer, liquidity provider, swap counterparty, underwriter, trustee, and investor, the types of risks may be less obvious and more complex than when encountered in the traditional lending process.

Recent developments in India

There were major developments in the area of securitisation and direct assignments during last few years, which are further supplemented by commercially incisive law and regulation, be it stamp duty relaxations or the modifications to RBI guidelines around securitization from time to time. Other measures that have spurred the securitisation market in India include the RBI temporarily relaxing the Minimum Holding Period requirements for NBFC originators. The relaxation allowed a larger asset pool to be eligible for securitisation by NBFCs.

The NBFC crisis has clearly led to a surge in securitisation and assignment transactions across the financial services sector in India. Over the years, there has been greater variation in the pool of assets being securitised or assigned for example education loan, auto & vehicle loans, finance lease receivables, microfinance and retail & consumer durable loans. As NBFCs continue to innovate new and varied products and portfolios, the securitisation market too will see an increased spread across asset classes and products.

Securitisation is considered as one of the cost-effective options by Banks, Financial institutions and NBFCs to meet their minimum priority sector lending ("PSL") requirements. In most of the cases, NBFCs remain originators having better reach to these segments qualifying as PSL, while some banks use this route to satisfy their PSL commitments as an investor; instead of originating loans directly to this sector owing to their limited geographical reach. Investors or assignees can diversify their risk with an access to a broader asset base across sectors using securitisation route. Following the recent crisis involving IL&FS and DHFL, the securitisation option provides access to alternative sources of funding to NBFC originators, where traditional sources may not be as easily available.

Regulatory initiatives:

The Reserve Bank had issued Guidelines on Securitisation of Standard Assets inclusive of direct assignment transactions on 1st February 2006, which were subsequently updated by introducing the minimum holding period and minimum retention requirement on 7th May 2012. These were further updated with inclusion of guidelines regarding reset of credit enhancements on 1st July 2013.

The latest draft framework for securitisation of standard assets was placed along with draft framework for sale of loan exposure from RBI released for discussions on 8th Jun 2020. This framework take into account the recommendations of the Committee on Development of Housing Finance Securitisation Market in India chaired by Dr Harsh Vardhan and the Task Force on the Development of Secondary Market for Corporate Loans chaired by Shri T.N. Manoharan, which were set up by the Reserve Bank in May, 2019.

Key Features and likely market implications:

- The proposed guidelines are much more detailed and sophisticated, in the way they look at the underlying transactions as compared to the earlier guidelines. For example: different approaches for Minimum Retention Requirement, proposition on listing the securities issued in a securitisation basis Product types / Tranche Size threshold, representation and warranties from originator and capital implication etc.
- Broder coverage: Mortgage backed securitization and wide spectrum of other types of securitization. Almost all standard exposures except revolving credits, Loans

with bullet repayment of both principal and interest and Securitisation Exposures.

- Proposes to allow for single asset securitization as opposed to the current situation, both domestic and global, where the securitization business is dominated by pooled asset securitization (typically home loans). Here the involvement of Special Purpose Vehicle (SPV) and credit enhancements will make it more secured as compared with direct assignment transaction to investor without any association of either of them.
- Bank can covert large loan into securities provided it fulfil all the regulatory prerequisites thus mitigating the credit concentration risk. Single asset securitisation is very important and interesting development. This will help bank securitizing their standard assets, if they need liquidity by churning the same.
- Revolving structures are also possible in this proposition. Revolving structures are the ones where underling assets can be replenished. This will need extensive discussion amongst market participants for exploring this further.
- Credits of revolving nature are not permitted (CC, Credit card receivables) but it proposes to allow securitisation of receivables acquired from elsewhere, provided they are held for a period of 12 months. A minimum holding period of 12 months will safeguard against misuse of this provision.
- The proposed directions clarify that disallowance on bullet loans is only in cases where both principal and interest are payable on maturity. This leads to an interpretation that in loans where the interest is regularly serviced, but the principal is paid as bullet repayment, the asset will remain eligible for securitisation.
- The proposed directions provide details description on parties to transaction for example: Trust -SPV, originator, liquidity supports to SPV, servicers, credit enhancers etc. and their responsibilities
- Approach to capital computation is much sophisticated: External rating approach (mandatory for NBFC and HFC) and Standardized approach. A very high-risk weight of 1250% is assigned for transactions that do not fall under securitized framework. This is however marked “work in progress” due to its limiting nature. The regulator is likely to take a call in the future based on the volume of transactions taking place.
- Simple, Transparent and Comparable Securitisation Transactions, that are Congruent with a very standardized underlying asset pool will attract less capital. Hence, the capital requirement for pool of assets with common risk drivers including similar risk factors and risk profiles will be much lower. For example: Housing loan portfolio and infrastructure portfolio.
- The new proposed framework has a lot more disclosure requirement as compared to the earlier guidelines, in a bid to achieve far greater transparency. This is critical for orderly market evolvement.
- There is a need for a quick encouraging movement in right directions towards implementation on this from other regulatory government agencies involved in the complete cycle of securitisation (tax authorities etc.)
- Bankruptcy remote nature of SPV in case the originator goes bankrupt is something that can be enforced by Government agencies other than RBI. This shall be part of bankruptcy law for financial institutions that is not in place at present. Till such time there will be uncertainties around the Bankruptcy remote nature of SPV.
- SEBI need to encourage Mutual Funds to start actively considering these securitized papers for investments.
- Large long-term loans that are currently syndicated by a group of bankers can be co-originated by few banks and securitized to wider set of investors. Regulator is keen on seeing how this takes shape further.
- Other institutional developments are a key prerequisite such as more entities for providing credit enhancements as against originator providing the first loss and NBFC HFC providing the second loss at present
- Third party servicers (BPO operators) like the one in the developed market are also required. Even if the originator goes bankrupt; these entities credibly service the loan.

Apparently, the way “securitisation” is defined in the proposed framework gives an impression that it is restrictive to multiple tranches. Definition of securitisation shall also include single tranche transactions. Most of the securitisation transactions in our local markets are plain vanilla structures with homogeneous assets and do not usually have multiple tranches. As per the current definition these transactions will not fall under the regulatory definition and hence may be mapped with a very high-risk weight of 1250% making them non-viable as investments.

Support from regulatory bodies (RBI, SEBI, Tax authorities etc.), market innovations and continuous efforts for enhancing asset liquidity for all types of assets in the book of financial institution will act as prime movers for an exponential growth envisaged in domestic standard asset securitisation market ahead.

Citation

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