Indian Securitisation- Regulatory and Market Scenario

-August 2007

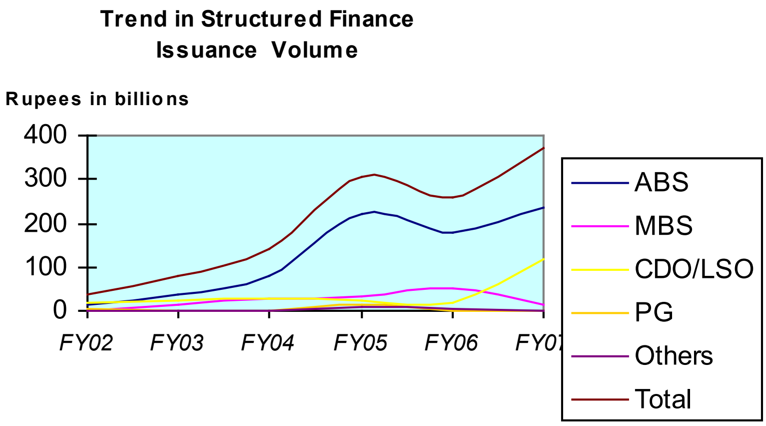
Introduction

Securitisation in India is of recent origin but has seen deals that exhibit both diversity as well market maturity. There have been two mainstays of the Indian market: RMBS deals and Auto-ABS deals. RMBS is now a standard and stable market with several players coming out with repeat issuance, either through the apex refinancing body National Housing Bank, or directly. Auto-loans have been securitised since 1990 – this is essentially a quasi-securitisation market as the resulting paper is not marketable. However, there have been some interesting deals: securitisation of future flows, infrastructure projects, one CMBS deal, etc. The law - Securitisation, Asset Reconstruction & Enforcement of Security Interests Act emerged in 2003, though the law deals with enforcement of security interests as its focal point and has not been used at all for securitisation transactions. Some bottlenecks in form of stamp duty and mortgage transfer registration still remain to be resolved in India.

While credit support levels granted by the originator remain very high, the transaction structures have evolved over time. From unstratified pass-throughs, the market has several types of multi-tranche paper now, including prepayment protecting, and prepayment-protected classes. Considering the newfound interest in project finance, securitisation of toll receivables and other receivables from infrastructure projects may increase. Another important growth area is the securitisation of lease receivables, prominent lease finance companies and the Indian Railway Finance Corporation (a central government organization) recently securitised their lease receivables

Market activity

During financial year 2007, Indian Structured Finance market grew by 44% over the previous year amounting to Rs. 370 billion. Securitisation of single corporate loans climbed up the stairs and amounted for one-third of the total issuances. Non Mortgage Backed Securities being the largest product class accounted for 64% of the Structured Finance Market. The Residential Mortgage Backed Securities experienced a 10% rise and accounted for Rs. 16 billion, i.e. less than 5% of the total issuances. During the year around 65% of securitised assets were originated by banks and the balance by non-banking financial companies. The following graphic shows the growth path[1]:



Volumes (Rs. In billions)						
	FY02	FY03	FY04	FY05	FY06	FY07
Asset Backed Securities	12.9	36.4	80.9	222.9	178.5	234.2
Mortgage Backed Securities	0.8	14.8	29.6	33.4	50.1	16.1
Collateralized Debt Obligation/ Loan Sell-off[2]	19.1	24.3	28.3	25.8	21.0	119.2
Partial Guarantee	4.0	1.9	0	16.0	0	0
Others	0.0	0.4	0.5	10.0	6.8	0
Total	36.8	77.7	139.2	308.2	256.5	369.5

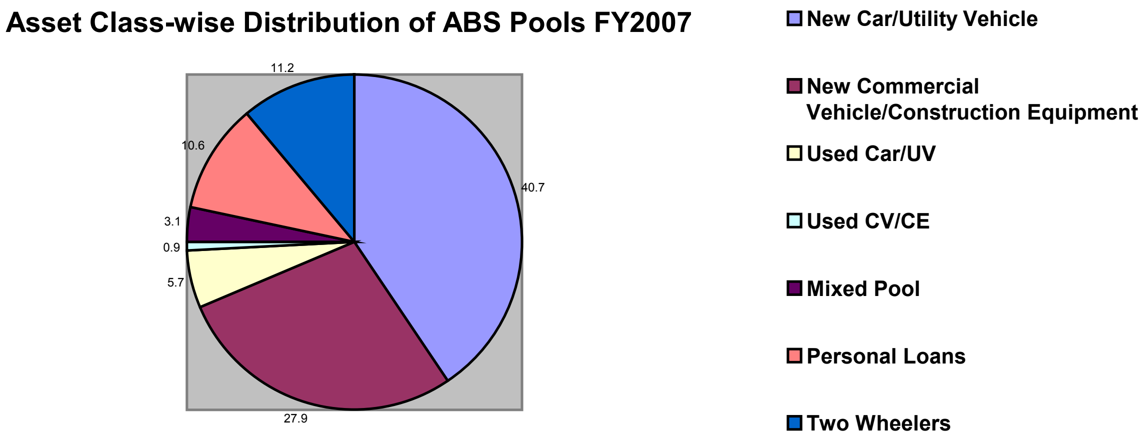
The figure above clearly shows a decline in Securitisation activities in the year 2006, this down fall was owing to the issue of RBI Guidelines on Securitisation transactions. However the market again picked up momentum in 2007 with the prospect of capital relief on securitisation and the continuous growth of retail loan portfolios. In FY 2007, some major players in the retail loan industry have securitised a significant portion of their retail loans owing to the tight liquidity conditions of the industry.

Asset classes

Over time, the market has spread into several asset classes – while auto loans and residential housing loans are still the mainstay, there are corporate loans, future flows, project receivables, toll revenues, etc that have been securitised. CMBS transactions that are characteristic of the Western world – where the commercial real estate itself is the real collateral, are still not common. The Asset Backed Securities was the main product class for FY 2007 accounting for 64% of the total issuances. The major underlying asset was new cars and utility vehicle. A diagrammatic representation of the Asset wise distribution of Asset Backed Securities is shown below[3]. A notable feature is decline in share of Personal loans in the market; the reason anticipated is the RBI Guidelines, which provides less or no capital relief on securitisation of personal loans.

---

[1] The data has been taken from ICRA Structured Finance Report FY 2007
[2] Loan sell-off is Securitisation of individual corporate loans
[3] The data has been procured from ICRA Structured Finance Report FY2007



Reserve Bank Guidelines and Capital Relief

In February 2006, Reserve Bank of India issued such guidelines such as to takeaway the main attractive feature of Securitisation. The guidelines prohibit originators from booking up profits upfront at the time of Securitisation, stipulate a higher capital charge on credit enhancements provided, and disallow release of credit enhancement during the course of transaction. The securitisation activities in the country slowed down with onset of these guidelines and the originators started to assign loan pools to investors rather than transferring it to an SPE or SPV, thus staying outside the Securitisation periphery. These guidelines can prove to be a severe blow to Indian securitisation market, especially when most of the developed countries have wholeheartedly accepted Basle II norms and are enjoying capital relief for Securitisation.

The illustration below shall bring out clearly the capital relief in different circumstances: Assuming a pool of asset securitised (personal loans) is 1000 and the bank retains 10% of the securities issued by SPE/SPV for credit enhancement i.e. 100 (50 unrated first loss piece, and 50 rated atleast investment grade second loss piece). The risk weight for personal loans is 125%. The capital relief in different scenarios will be as follows:

	Before the RBI Guidelines in Feb 2006	After the RBI Guidelines in Feb 2006	Under Basle II
Capital Relief on Pool Securitised	9%*1000=90	9%*1000=90	9%*(125%*1000)=112.5

Prior to Reserve Bank guidelines, there was no exceptional requirement for maintaining capital on credit enhancement and the regular compliance was met by holding capital at prescribed capital adequacy rate as applicable for other assets. However in Feb 2006 the Reserve Bank issued guidelines which stipulated that the bank should hold capital against the credit risk assumed when it provides credit enhancement, i.e. a rupee of capital is required for every rupee of credit enhancement. On one hand where the RBI guidelines have taken away one of the key incentive for securitisation in India, the rest of the world is complying with Basle II norms which stipulate a capital requirement of 100% for the first loss piece, and no special requirement for second loss piece. Hence the second loss piece held by the originator requires only normal capital adequacy requirement i.e. at the rate applicable for other assets. The capital for credit enhancement and the overall relief will be as follows:

	Before the RBI Guidelines in Feb 2006	After the RBI Guidelines in Feb 2006	Under Basle II
Capital Requirement for Credit Enhancement	9%*100=9	100%*100=100	(100%*50)+(9%*50)=54.5
Overall Relief=Capital relief on Pool Securitised-Capital Requirement for credit enhancement	81	10	58

It is quite evident from the above table, that overall relief is curtailed but Basle II compliance in India as suggested by RBI circular on capital adequacy, will be a comfort for Indian Securitisation Market. The risk weight for personal loans and credit cards is 125% and that of regulatory retail loans is 75% implying a capital relief of 11.25% and 6.75% respectively under Basle II, thus showing a greater incentive for securitisation of personal loans and credit cards.

Legal Structure

In 2002, India enacted a law "Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002", more commonly called SARFAESI Act. The act deals with an instrument called "security receipt", but since only securitisation or asset reconstruction companies under the SARFAESI Act can issue security receipts, the act is limited to asset reconstruction companies only.

However the Securities Contracts (Regulation) Amendment Bill, 2007 passed by Lok Sabha in month of May 2007 amended Securities Contract (Regulation) Act to include "securitised instruments" in the definition of "securities" as defined in Securities Contract (Regulation) Act. The amendment is made to allow listing of securitised debt on stock exchanges and therefore, make the market more liquid. SEBI has been empowered to write regulations for public offers and listing, and it has come up with draft regulations which is placed on its website. Instead of falling in line with similar public offer rules for asset-backed securities in other countries, for example, Regulation AB, SEBI has drawn heavily on its own template in context of mutual funds and similar market intermediaries. Thus, for a securitised instrument to be offered to public, there has to be a special purpose distinct entity (read SPV). While the normal concept of SPVs is a discrete body for each transaction, SEBI's idea seems to be some kind of a continuing umbrella entity that would serve several transactions in a sequence. Hence, there is a need for registration of such entity, and such registration must be maintained on a continuous basis. A single SPV can come up with several transactions of securitisation, called "schemes", again in line with mutual fund parlance. Hence, the SPV becomes a kind of protected cell or multi-segmented entity, though the law in India currently does not have any cell protection rules. Once the SPV is registered, it can, over time, bring public offers by having an offer document, which would also need to be registered with SEBI. There are scanty disclosure requirements in the offer document, which obviously indicates that SEBI did not have the benefit of similar disclosure requirements either from SEC USA or from industry bodies.

Vinod Kothari

Vinod Kothari Consultants Pvt Ltd

1012 Krisna Building, 224 AJC Bose Road

Kolkata-700017, Ph- 9133 22811276/2281 7715

email: vinod@vinodkothari.com

website: http://www.vinodkothari.com/