INDIAN SECURITISATION MARKET

Vinod Kothari

[This is an extract from a Chapter in forthcoming book by the author – references to other Chapters/parts thereof refer to the rest of the portions of the Book]

Securitisation as a financial instrument has been in practice in India since the early 1990s – essentially as a device of bilateral acquisitions of portfolios of finance companies. As would be the case elsewhere too, securitisation in its initial form finds its way in loan sales. There were quasi-securitisations for quite a while where creation of any form of security was rare and the portfolios simply ended from balance sheet of one originator over to that of another. Most of these transactions were backed by extensive originator support. As there were no rules as to regulatory capital requirements, most of the so-called securitisation investors were actually taking exposure on the balance sheet of the originator.

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.

Having started sometime in 1996 or thereabouts, securitisation volumes have been scaling new peaks every year. The party continued till about 2005. In early 2006, the RBI came out with guidelines on regulatory capital treatment for securitisation – these dealt a severe blow to the securitisation market, and in 2006, the volumes are expected to be lower than those in 2005.

The RBI Guidelines are discussed at length in a later Chapter, along with clause-by-clause impact. The overall impact of the Guidelines on the securitisation market is discussed in this Chapter.

Market overview and Volumes:

The market for securitisation zoomed from 2002 to 2005, with a cumulative growth rate of nearly 100%. The following graphic, taken from an ICRA report, shows the growth path:

Number of transactions						
	FY01	FY02	FY03	FY04	FY05	FY06
ABS	5	15	41	53	78	78
MBS	3	3	10	15	15	17

CDO	-	4	-	2	3	0
PG	2	3	2	-	2	0
FFT	4	-	1	-	0	0
LSO	-	-	19	17	25	30
Others	-	-	-	1	4	5
	14	25	73	88	127	130

Volumes (Rs. In billions)					
	FY02	FY03	FY04	FY05	FY06
ABS	12.9	36.4	80.9	222.9	178.5
MBS	0.8	14.8	29.6	33.4	50.1
CDO	19.1	24.3	28.3	25.8	21.0
PG	4.0	1.9	0	16.0	0
Others	0.0	0.4	0.5	10.0	6.8
	36.8	77.7	139.2	30.8.2	256.5

Sometime back, Standard and Poor's reported the Asian securitisation data for 2003, and it was a pleasant surprise to note that India was no. 2 in ex-Japan Asia in terms of volumes, next only after Korea. Though the gap between India and Korea is huge, but the Indian market continues to zoom through 2004. Data for the first half of 2004-05 (upto Sept 2004) revealed that the market has already crossed a volume of Rs. 10,000 crores in the half year, which is nearly 4 times the volume for the same period last year.

In financial year 2004-5 and larger part of 2005-6, volumes continued to surge. Innovative transactions with prepayment protected tranches, etc kept on emerging in the market. The scenario became really heated up with the Finance Minister announcing in his Budget Speech that (a) the definition of the term 'security' under the Securities Act will be amended to allow trading of securitisation instruments[1]; (b) a committee to look into all aspects of bonds and securitisation transactions will be appointed[2].

Most issuers will have to postpone new issuances in view of the RBI guidelines, which will surely slow down the market for some time[3]. The situation may improve with the passage of the proposed amendment to the Securities Contracts Regulation Act, which is supposed to open the secondary market for securitised papers. This will encourage the entry of new investors in the market. Considering the booming economy and ever increasing volumes of foreign investment in the Indian capital market, the securitisation market may stabilize by 2007. Certain new forms of securitisation such as securitisation

[1] We discuss this amendment later in this Chapter.
[2] The R H Patil Committee report is discussed later in this Chapter.
[3] See the relevant section for a detailed comment on the guidelines.

by corporates especially future flows securitisation and infrastructure project receivables securitisation should grow.

As we will be discussing later in this Chapter, the motives of the originators have so far been (a) booking of gains on sale, taking advantage of the very minimal accounting rules and no rules from the regulators so far; (b) full capital relief, as there were no regulatory guidelines requiring capital for the originator's credit support to securitisation transactions; (c) liquidity, particularly in case of non-banking financial companies. There has been very little arbitrage activity in the market. There have been CLOs, but many of them are either single borrower transactions, or transactions with low diversity score, and hence, backed by substantial extent of credit enhancements.

Several of the drivers that have clearly boosted volumes in global markets are still not present in India – there is virtually no CMBS activity[4]. There is no activity in respect of credit cards, probably either because the costs in terms of stamp duty are prohibitive, and/or because originators do not have sufficient volumes to think of securitisation. There are no arbitrage CLOs. There is virtually no CBO transaction to date. There are scattered future flows transactions, but there could be lot more given the size of the country's economy.

Form of security:

In the later part of 1990s, creation of transferable securities in the form of pass-through certificates (PTCs) became common. The word PTC has almost become synonymous with securitisation in India and most market practitioners do not envisage issuance of notes or bonds as a securitised product. A typical Indian PTC does not abide by any specific structural features – there are PTCs which have a specific coupon rate, there are structured PTCs and there are PTCs that have different payback periods. In other words, many such PTCs are essentially debt instruments – it is only that they are not called as such.

The issuance of PTC has so intensely been associated with the market that even for completely bilateral deals, which are really speaking loan sales, people have used trusts and PTCs.

The selection of the form of security is often dominated by the intention to save Stamp Duty. The Securities Contracts Regulation Act is supposed to be amended to include PTCs issued in securitisation within the definition of securities under the Act. As and when this happens it will surely encourage more investments in the securitised papers.

The SARFAESI Act deals with an instrument called "security receipt", but since security receipts can only be issued by securitisation or asset reconstruction companies under the SARFAESI Act, these are limited to asset reconstruction companies only. Note, as discussed later in this Chapter, that the SARFAESI Act has not been used at all for securitisation transactions.

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[4] There are, however, real estate investment trusts in the garb of venture capital funds.

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.

Early attempts to bring CLOs/ CDOs to the market by ICICI did not succeed. However, subsequently, there have been several private placement deals where either single corporate loans, or single corporate bonds, have been brought to the market. Some of them have highly questionable structures – for example, where the risk weight applicable on a corporate bond (100%) is supposedly being brought down to 20% due to a put option being given by the sponsoring bank. These aberrations are there in any market, and the sooner they die down, the better.

During 2004-05, several CLO transactions have surfaced, essentially from viewpoint of capital relief. However, arbitrage CDOs are yet to emerge in the market.

Revolving structures are still not there. ABCP conduits also do not exist.

Transactions are both rated and unrated. Transactions are both listed and unlisted. 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.

Transaction structures:

The evolution of transaction structures in the market can be observed as under:

- Simple, one class structure with substantial extent of residual interest retained by the seller
- Time tranching of cashflows, with some classes taking all payments during first few months
- Prepayment protected classes and prepayment protecting classes
- Re-securitisation of securitized receivables

A remarkable feature of the market is the virtual absence of rated mezzanine tranches offered to investors. Until the RBI Guidelines discussed below, there was no reason for the mezzanine market to exist, as the originators could retain a sizeable chunk of first loss piece without any capital consequences. The RBI Guidelines will surely force a mezzanine market to emerge, and in the near future, structured finance resecuritisations, which bundle mezzanine structured finance investments into securities, seem to be a distinct possibility.

The credit enhancements have so far been sized extremely conservatively. The sizes have ranged from 8% to 15% or higher. Credit enhancements have come in form of residual interests retained by the originators, cash collateral, excess spread, etc. In some cases, originators have provided put options on the securities offered to investors, thereby virtually ending up into a case of full recourse.

Several transactions have used a "staggered payment" structure where the payments collected in a particular month are staggered in a certain ratio and released in the next, or next to next month. Possibly, the objective of this structure is to avoid the fluctuations in monthly collections affecting investors, but these structures introduce commingling risk and by allowing the originator to create a mismatch between what he collects and what he passes over, make the legal structure weak.

Assuming that the mark of maturity of the securitisation market is the declining levels of credit enhancements, the market has not come of age, but surely is moving in that direction. The credit enhancement levels are still substantially higher than those in matured markets. The Table below shows credit enhancement levels in several ICRA-rated transactions:

Month	Originator	Transaction	Form of credit enhancement	Size
May-06	Tata Motors Ltd	BHPC Auto Securitisation Trust May 2006	Bank guarantee	
			Subordination of overdues	
Apr-06	Standard Charterd Bank	Mortgage Loan Pool Trust 2006 – II	Cash collateral	
Mar-06	ICICI Bank	direct assignment of 2 wheeler loan pool	Credit collateral	
			Subordination of overdues	not speci
Apr-06	Sundaram Finance Ltd	Sundaram Finance Ltd 2006-3 and 4	Cash collateral	6%;
			Subordination of overdues	0.11 0.22
Mar-06	Tata Motors Limited	Tata Motors 2006 ABS 2	Bank guarantee	
			Subordination of overdues	
Feb-06	Sundaram Finance Ltd	Sundaram Finance Ltd 2006-2	Cash collateral	
			Subordination of overdues	
Feb-06	Sundaram Finance Ltd	Sundaram Finance Ltd 2006-1	Cash collateral	
			Subordination of overdues	
Jan-06	Standard Chartered Bank	Standard Chartered Bank (2005) MBS 1(Mortgage Loan Pool Trust 2005 - I	Cash collateral	
			Excess spread	NA
			Liquidity reserve	
			Yield reserve	
Sep-05	ICICI	[ICICI Bank Limited (2005) ABS 8 (Indian Retail ABS Trust Series XL)}	Credit collateral	

			Subordination of overdues	not speci
Jan-05	ICICI	ICICI Bank Limited (2004) ABS 8 (Indian Retail ABS Trust Series XXIV)	Cash collateral	
			Excess spread	NA
Jan-05	ICICI	[ICICI Bank Limited (2004) ABS 9 (Indian Retail ABS Trust Series XXVII)}	Cash collateral	
			Excess spread	
			Subordination of overdues	
Jan-05	ICICI	[ICICI Bank Limited (2004) ABS 6 (Indian Retail ABS Trust Series XX)}	Cash collateral	
			Excess spread	
			Subordination of overdues	
Oct-04	ICICI	[ICICI Bank Limited (2004) ABS 5 (Indian Retail ABS Trust Series XIX)}	Cash collateral	
			Over-collateralization	
			Excess spread	NA
			Excess spread will be used to paydown principal	
Sep-04	UTI Bank Limited	UTI Bank Limited (2004) CLO 1 (Collateralised Debt Trust Series 1)	Subordination	

Notes:

1. All the above are based on press reports on ICRA website, compiled by Vinod Kothari
2. The dates above are dates of the ratings

Clearly, there is a change in both the form and the extent of credit enhancement subsequent to the RBI guidelines.

- The first change is that several originators have shifted from a securitisation structure to what is termed as "direct assignment" structure. A direct assignment is a bilateral portfolio sale – there is no SPV here as the buyer is an operating company or investor. In view of the language of the RBI Guidelines, it is felt that these transactions will not be covered by the RBI guidelines, which explicitly define securitisation to mean transfer of assets to SPVs. In the opinion of the author, this is a flagrant avoidance device and it would be clearly unfortunate if the regulators allow this to happen for long.
- 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.

"Direct assignments" replace "securitisation"

In what is clearly a reaction to the RBI's guidelines on securitisation, the form of transaction in several cases has been replaced by direct assignments. Direct assignments do not involve an SPV -they are purely bilateral transactions. However, there is no question of direct assignments reaching out to capital market investors. If the direct assignment is not merely of the receivables out of loans but of the entire loan agreement, in all probability the buyer should be a bank, or at least a non-banking finance company. The question of creating multiple tranches in direct assignments does not arise. In short, the entire flexibility of securitisation, which enables unbundling and repackaging of the loans to create structured finance securities, will all seem to go away in the direct assignment option.

The market view that assignments will not be covered by the RBI guidelines would also be only short-lived. Whether the RBI rectifies its draft to cover the so-called direct assignments or not, with the advent of Basle II guidelines, the treatment will be based on substance rather than on form. Thereore, capital requirements will still have to be based on first layer of loss support and not on the legal form of the transaction.

Motive for securitisation:

Since the prominent originators of transactions in the marketplace are banks and financial intermediaries, the primary motives in case of banks and financial intermediaries are essentially capital relief, profit stripping and liquidity.

Capital relief as a motive will possibly hold for NBFCs and some highly leveraged banks. However, if capital relief was the stronger motive, synthetic transactions would have provided a better solution. Synthetic transactions have also not emerged as yet. In fact, even for most cash transactions, capital relief does not sound like a very significant motive either because the volumes are not large enough have any tangible impact on the regulatory capital of the securitisers, or because the regulatory capital is not highly leveraged.

Thus the primary motive for most securitisers would be the skimming of excess spreads; for some, liquidity needs are obvious. The impact of securitisation on reported profits is quite obvious looking at the reported statements of some of the prominent originators. For example, ICICI reported, in fiscal 2004-5, a net interest income of Rs.28.39 billion. Compared to this, gains on sale of securitized portfolio were Rs. 5.21 billion. In other words roughly 18% of the reported interest income came from securitisation sell downs, valued at about Rs. 160 billion.

The RBI Guidelines do not deal with synthetic securitisations. We are of the opinion that in the absence of any specific prohibition on synthetic securitisation, Indian companies are free to undertake synthetic securitisations.

Investors and investor motives:

Investments in securitisation transactions mostly come from insurance companies, mutual funds and banks. The life insurance companies find the AAA rating and higher spreads as

particularly attractive. For a life insurer, the prepayment risk is a significant risk, as life insurance companies need to maintain investments in order to make their embedded profits. Nevertheless, these companies have been significant investors in securitisation transactions.

Investors are clearly driven by yield motives. Several prepayment protected issuances have come up in the market recently – making it easier fixed income and fixed maturity investors to pick up asset backed securities.

Nature and form of credit enhancements:

Subordination is a commonly used form of credit enhancement. Since asset backed securities are still new, investors have a preference for AAA instruments. In case of asset backed securities backed by pools, there have been very few less than AAA deals that have been placed with investors. Of course, in case of CLOs, particularly those backed by singular loans, lower ratings have been common. Most transactions in the market, therefore, end up with a couple of senior classes. Multi-class issuances with several rated tranches are uncommon.

Apart from subordination, over-collaterlisation, guarantees, recourse, cash reserves are used as other forms of enhancement. The extent of enhancements is relatively very high – and not very painful, as there are no capital consequences of providing such enhancement – see below.

Legal structure:

In 2002, India enacted a law that reads Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 (SARFAESI) (see later part of this Book). Though masquerading as a securitisation-related law, this law does very little for securitisation transactions and has been viewed as a law relating to enforcement of security interests, as a very narrow avatar of personal property security laws of North America. In commercial practice, the SARFAESI has been very irrelevant for real life securitisations.

Most securitisations in India adopt a trust structure – with the underlying assets being transferred by way of a sale to a trustee, who holds it in trust for the investors. A trust is not a legal entity in law – but a trustee is entitled to hold property that is distinct from the property of the trustee or other trust properties held by him. Thus, there is an isolation, both from the property of the seller, as also from the property of the trustee. The trust law has its foundations in UK trust law and is practically the same.

Therefore, the trust is the special purpose vehicle. Most transactions to date use discrete SPVs – master trusts are still not seen.

The trustee typically issues PTCs. A PTC is a certificate of proportional beneficial interest. Beneficial property and legal property is distinct in law – the issuance of the PTCs does not imply transfer of property by the SPV but certification of beneficial interest.

In absence of the securitisation law not coming to the help of securitisation transactions, India is at par with several common law countries which do not have specific securitisation statutes, but rely on the rich and flexible common law traditions to carve out securitisation transactions. However, absence of a legal regime significantly affects legal thinking on the following:

- True sale. On the face of it, it is futile to write a law on true sale, because the whole concept of "true sale" is a "sale" which is "true". While the law may easily define a "sale", whether such sale is truly a sale or not is, by definition, a question of examination and observation. Hence, true sale is a question of determination, and not a subject matter of law. The RBI guidelines of Feb 2006 make the mistake of laying down at least some features of what will be true sale. For instance, the RBI guidelines say that retention of residual interest in a pool of assets will not be inconsistent with true sale, whereas caselaw suggests to the contrary. This and other prevailing notions in the marketplace have prejudiced legal thinking, which continues to affect transactions.
- While law may not define a true sale, law may surely define whether fractional transfers of assets, transfer of future receivables, etc are legally recognized, and how the same will documented. There is significant confusion at present about these also.

More than the common law of securitisation, the larger stumbling blocks in India are stamp duty, and an age-old registration law.

Stamp duty arises from the fact that a transfer of "actionable claims" (which term includes most receivables) will require a written instrument, and such instrument is treated as a "conveyance" in law, meaning a document whereby legal interest is conveyed in property. A conveyance is a stampable document, and most states impose stamp duties ranging between 3% to 15-16% on the value of the property being transferred in a conveyance. Since this would completely rule out any securitisation transaction, several states have relaxed their duties applicable on securitisation transactions – mostly to provide for 0.1% duty on the value of receivables being transferred. The annexure to the R H Patil Committee report provides an update on the stamp laws of different states; besides, stamp duty notifications of several states are also appended in the annexures to this Chapter.

Registration requirements also, literally applied, will come in the law of several securitisation transactions. A transfer of receivables backed by mortgage of immovable property is itself taken as a document transferring immovable property, and hence, requires registration. Registration is both cost and a bother. As a way out, in many cases, the mortgage interest is retained with the seller, who continues to hold the same as trustee for the buyer.

The RH Patil Committee report:

The Finance Minister, in his Budget 2005 speech, emphasized the need to develop market for bonds and securitized instruments, and accordingly, a committee High Level Expert Committee was constituted under the Chairmanship of R H Patil to make recommendations. Among other things, the Committee made several recommendations about ironing out the legal difficulties relating to securitisation transactions. The committee dedicated a whole section to securitisation transactions. The report of the Committee was released in Dec. 2005.

Since the recommendations are relevant for securitisation markets in India, excerpts from the report are appended to this Chapter.

Amendment of the definition of "securities" under the Securities Act:

The Securities Contracts (Regulation) Amendment Bill, 2005 was introduced in the Lok Sabha on 16.12.2005 pursuant to the announcement in Budget 2005-06 regarding provision of a legal framework for trading of securitised debt including mortgage backed debt. The Bill stands referred to the Standing Committee on Finance.

This Bill, once enacted, on one hand will allow for the listing of securitized debt on stock exchanges and therefore, make the market more liquid, yet, at the same time, it also seeks to insert a new section 17A in the Securities Contracts Regulation Act whereby regulatory powers on securitisation transactions are sought to be conferred on SEBI. If SEBI, like its counterpart in terms of Regulation AB in the USA, keeps limited to only public offering of securitized paper, the regulation is reasonable. However, if regulation is extended to all offers of securitized paper, it would amount unwarranted burden on the market.

Securitisation guidelines of the RBI:

One of the most significant developments relating to securitisation in the recent past is the issuance of securitisation guidelines by the RBI in Feb 2006.

There is no question that regulatory guidelines on securitisation were most necessary, and that the market was making rampant misuse of securitisation with substantial first loss support provided to most transactions without bothering at all about regulatory capital. However, the RBI guidelines have several shortcomings. Detailed comments on the RBI guidelines, along with text thereof, have been put as a separate chapter in this book.

Regulatory capital and Basle II:

Basle II is sought to be implemented in India from 31st March 2007. At first, banks will be required to compute capital as per standardized approach, and subsequently, on the RBI's satisfaction of ability and dependability, selected banks may be allowed to use the IRB approach too.

It is expected that the securitisation framework of the Basle II guidelines will also be implemented when the rest of the Basle II rules are implemented.

Basle II provides for ratings-based risk weights in case of securitisation transactions. These rules also, in case of originators, require for full deduction from capital to the extent of exposures which are rated less than investment grade.

Regulatory compliances:

Among the regulatory costs, stamp duty is a major hurdle. The instrument of transfer of financial assets is, by law, a conveyance, which is a stampable instrument. Many states do not distinguish between conveyances of real estate and that of receivables, and levy the same rate of stamp duty on the two. The rates would therefore be weird – going up to 10% of the value of the receivables. Some 5 states have announced concessional rates of stamp duty on actionable claims, limiting the burden to 0.1%, but there is an unclarity as to whether this concession can be availed for assets situated in multiple locations.

The stamp duty unclarity and illogicality has in a way shaped the market – players have limited transactions to such receivables as may be transferred without unbearable stamp duty costs. The SARFAESI law intended to resolve the stamp duty problem, but owing to its flawed language, did not succeed.

Comment: Meaning not clear.

Taxation:

The tax laws have no specific provision dealing with securitisation. Hence, the market practice is entirely based on generic tax principles, and since these were never crafted for securitisations, experts' opinions differ.

The generic tax rule is that a trustee is liable to tax in a representative capacity on behalf of the beneficiaries – therefore, there is a prima facie taxation of the SPV as a representative of all end investors. However, the representative tax is not applicable in case of non-discretionary trusts where the share of the beneficiaries is ascertainable. The share of the beneficiaries is ascertainable in all securitisations – through the amount of PTCs held by the investors. Though the PTCs might be multi-class, and a large part might be residual income certificates in effect, the market believes, though with no reliable precedent, that there will be no tax at the SPV level and the investors will be taxed on their share of income.

The scenario is, however, far from clear and the current thinking may be short lived.

Accounting rules:

The Institute of Chartered Accountants of India has come out with a guidance note on accounting for securitisation. Guidance notes are issued by the Research Committee of the Institute and are recommendatory rather than mandatory. But where a method is recommended, it is expected to be followed, unless there are reasons not to.

The guidance note is a mix of FAS 140 and FRS 5 approach. Generally, off balance sheet treatment is allowed, if risks and rewards are transferred. Gain on sales is computed based on the components approach underlying the US accounting standard. Originators are required to estimate the fair value of retained interests, and retained liabilities and apportion the carrying value of the asset in proportion of such retained and transferred interests.

The guidance note also makes a reference to accounting for SPVs – without caring for whether the issuance of securities by the SPV leads to a transfer of beneficial interest. Literally interpreted, the accounting rule suggests that assets transferred to SPVs should stay on the balance sheet of the SPV in all cases, which is neither the international practice nor an understandable accounting rule.