

LEARNING FROM INDIA'S FIRST CDO

EXPOSURE: ON WHOM IS THE INVESTORS' EXPOSURE?

A clarification on whether investing in securitisation instruments is exposure to the originator or to the SPV is important. It is crucial that the isolation from the originator be established and for the comfort of the investor clearly stated by the Reserve Bank of India. In the case of ICCDO most of the major investors have a very high exposure to ICICI. A clarification to investors from RBI to this effect would be a necessity if any of the banks were expected to invest in ICCDO.

The method of obtaining this clarification from RBI is as follows: -

- ~~/~~ First, an investing bank has to write a letter seeking a clarification pertaining to exposure for this specific issue.
- ~~/~~ A new structure necessitates an explanation of the instrument to various people at RBI ranging from a Deputy Governor to a Deputy General Manager.
- ~~/~~ The process is time consuming and hence should be done on a proactive basis. This time period has to be considered while planning a market issue where a similar clarification is required from the RBI.
- ~~/~~ For ICCDO, subsequent to the letter from a Bank to RBI, it took around 12-15 days to obtain the clarification. However it should be noted that the work on this front was started somewhere in the middle of February.
- ~~/~~ In the case of ICCDO, ICICI's relation with the regulator has played a major role in expediting the clarifications.

In the case of the ICCDO issue, RBI has confirmed that investment in this particular issue shall not be an exposure on ICICI. However this issue has not been resolved completely, for the simple reason that this letter from RBI does not state as to whom the investor is exposed to should he invest in the ICCDO.

All the same, this letter is very significant as it is the first time that the RBI has chosen to comment on any securitised instrument.

It may be interesting to note what the RBI working Committee says on this: -

Suggestion in RBI Working Committee Report:

"Banks and Financial Institutions investing in the ABS/MBS will get exposed to the pool of assets/mortgages/obligors underlying such securities. The institutions therefore, should guard against concentrations of exposures to a particular industry/sector, institution or geographic area.

In the case of a large number of underlying obligors, the exposure may be treated against this particular sector to which the pool of assets belong. In case there are one or two obligors, the exposure may be treated against those obligors. In case there are a few identifiable obligors, each of whom has the share of 25 per cent or more in the pool of assets, the exposure may be treated proportional against those borrowers."

It is to be noted that this is only a recommendation by a committee and does not have any regulatory value.

ELIGIBILITY CRITERIA FOR INVESTORS

Co-Operative Banks and Regional Rural Banks

Co-operative Banks are not allowed to invest in Mutual Funds except for schemes floated by UTI. This regulation did not allow them to invest in the ICCDO. Even RRBs are not allowed to invest in mutual funds. Co-operative banks cannot invest in corporate paper. RRBs are allowed to invest in corporate paper with a cap of 5% of their incremental deposits.

Mutual Funds

Mutual Funds preferred to stay away from the issue. The main reason has been the issuance of the securities in the form of Mutual Fund units. MFs cannot invest more than 5 % of their Net Asset Value in other mutual funds. If a Mutual Fund invests in another MF unit they also lose out on AMC fees. If Mutual Funds had come in as investors into this issue, it would have been a positive boost for secondary market liquidity of this instrument, as they (MFs) are the most active traders.

VALUATION OF THE PAPER IN THE BOOKS OF INVESTORS:

A major concern for investors is the valuation of this instrument. The confusion probably cropped up due to the fact that the instrument is to be traded like a other bond, however the valuation was to be done as per any other mutual fund unit. Its NAV was to be declared every week as is mandatory under SEBI rules.

Bank valuation is done on category wise basis, depending on which category the investment falls under viz. 'Available For Trading', 'Available For Sale' and 'Held To Maturity'. For 'Available For Trading' category, the valuation is done on a daily/ weekly basis, as and when the NAV is published.

In 'Available For Sale' category, the valuation is done on a quarterly / half yearly / annual basis and for 'Held To Maturity' category, no valuation is required. For valuation, the price considered is either the NAV or the repurchase price, whichever is lower.

CONCERN ABOUT THE UNDERLYING POOL OF ASSETS.

The inclusion of certain assets, which has defaulted on interest payments to institutions, has made investors skeptical about the motive behind this securitisation transaction. Investors wrongly felt that ICICI is trying to take out bad assets out of its books. The best way to allay these fears is if the Originator continues to hold some assets of the same Obligor, after securitising a part.

If to say that nearly all the assets continue to remain on ICICI's books.

However, it should be well emphasized to the investors that since it is very unlikely that all assets would default at the same time, the cushion in terms of cash reserve and tranching is sufficient to protect investors from any yield loss to certain extent.

SECONDARY TRADING IN THE PAPER:

ICICI agreed to provide Market Making in this instrument by way of daily two-way quotes. Besides that, the mutual fund units were also proposed to be listed on the NSE. However, investors still remained unconvinced about liquidity since this was a first time transaction, with no precedent to build their comfort level.

MARKETING STRATEGY

The marketing efforts have been stupendous and close to 400 presentations were made to the whole gamut of prospective investors. In our opinion, this exercise has increased market awareness of Securitisation and particularly CDO's tremendously. All the same in hindsight, we can possibly say that the following two strategies could have positively impacted the overall marketing.

Should the marketing have been top down or bottoms up?

Though both the approaches were taken, in our opinion, a higher and early concentration on a top-down approach would have worked better.

Absence of an early First Bid

With a complex first time structure, every investor seemed to want someone else to make a first bid. In our opinion, an early first bid would have elicited a much better response.