

Securitization in India – Opportunities & Obstacles

- A Discussion paper

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Abstract

Securitization has emerged globally as an important technique for bundling assets and segregating risks into marketable securities. This paper discusses the present nascent state of the securitization market in India, its potential and attempts to identify what needs to be done by various stakeholders in this market for securitization to grow to its full potential in India.

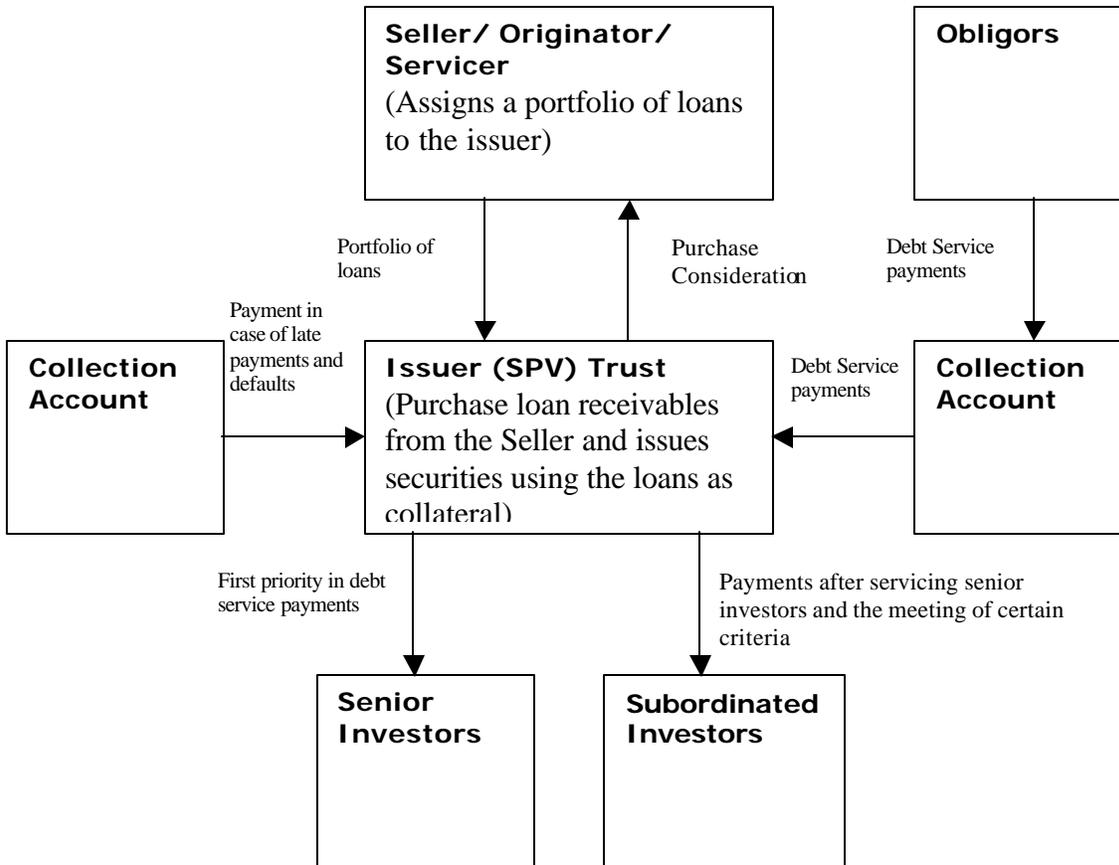
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Introduction

Securitization is the process of pooling and packaging Financial Assets, usually relatively illiquid, into liquid marketable securities. Securitization allows an entity to assign (i.e. sell) its interest in a pool of financial assets (and the underlying security) to other entities. Figure 1 below presents the structure of a Collateralized Loan Obligation (CLO) ¹, a typical securitization transaction.

Figure 1: Sample CLO structure.



In the above CLO transaction, the originator packages a pool of loans and assigns his interest therein, including the underlying security, to a bankruptcy remote & tax neutral entity which, in turn, issues securities to investors. The idea of such an exercise is to completely transfer the interest in pool of loans to the investors (a “true sale”) and achieve a rating higher than that of the Originator².

With the help of securitization transaction, an originator can transfer the credit and other risks associated with the pool of assets securitized. Securitization can provide

¹ CLOs are securities backed or collateralized by a diversified portfolio of secured or unsecured loans made to a variety of corporate commercial and industrial loan customers of one or more lending banks.

² Structured rating analytical criteria focus on how much credit enhancement is needed to achieve such a rating, and accompanying legal criteria focus on isolation of the assets from the credit risk of the seller.

much needed liquidity to an Originator's balance sheet; help the originator churn its portfolio and make room for fresh asset creation; obtain better pricing than through a debt-financing route; and help the originator in proactively managing its asset portfolio. Securitization allows investors to improve their yields while keeping intact or even improving the quality of investment.

Securitization in India

As of June 30, 2001, the outstanding securitized assets in the US were over USD 5 trillion (ABS - USD 1.2 trillion, MBS - USD 3.8)[3], a staggering 25% of all debt outstanding. For India, this figure is a paltry 1.6% with less than INR 100 billion of outstanding securitized debt. [3]

While there has been a lot of discussion about the potential of securitization in India, actual deal activity has not kept pace. While some early adopters like ICICI, TELCO and Citibank have been actively pursuing securitization, almost all the transactions in the market so far have been privately placed with a majority of them being bilateral fully bought out deals.

Lack of appropriate legislation and legal clarity, unclear accounting treatment, high incidence of stamp duties making transactions unviable, lack of understanding of the instrument amongst investors, originators and, till recently, even rating agencies are some of the glaring reasons for the lack of activity in the area of securitization in India.

Need for Securitization in India

The generic benefits of securitization for Originators and investors have been discussed above. In the Indian context, securitization is the only ray of hope for funding resource starved infrastructure sectors like Power³. For power utilities burdened with delinquent receivables from state electricity boards (SEBs), securitization seems to be the only hope of meeting resource requirements. As on December 31, 1998, overall SEB dues only to the central agencies were over Rs. 184 billion [1].

Securitization can help Indian borrowers with international assets in piercing the sovereign rating and placing an investment grade structure. An example, albeit failed, is that of Air India's aborted attempt to securitize its North American ticket receivables. Such structured transactions can help premier corporates to obtain a superior pricing than a borrowing based on their non-investment grade corporate rating.

A market for Mortgage backed Securities (MBS) in India can help large Indian housing finance companies (HFCs) in churning their portfolios and focus on what they know best – fresh asset origination. Indian HFCs have traditionally relied on bond finance and loans from the National Housing Bank (NHB). MBS can provide a vital source of funds for the HFCs.

After the merger of India's largest financial institution ICICI with ICICI Bank, ICICI, faced with SLR and other requirements, is actively seeking to launch a CLO to reduce

³ According to reports, the power sector in India needs a funding of about USD 17 billion over the next 10 years [1].

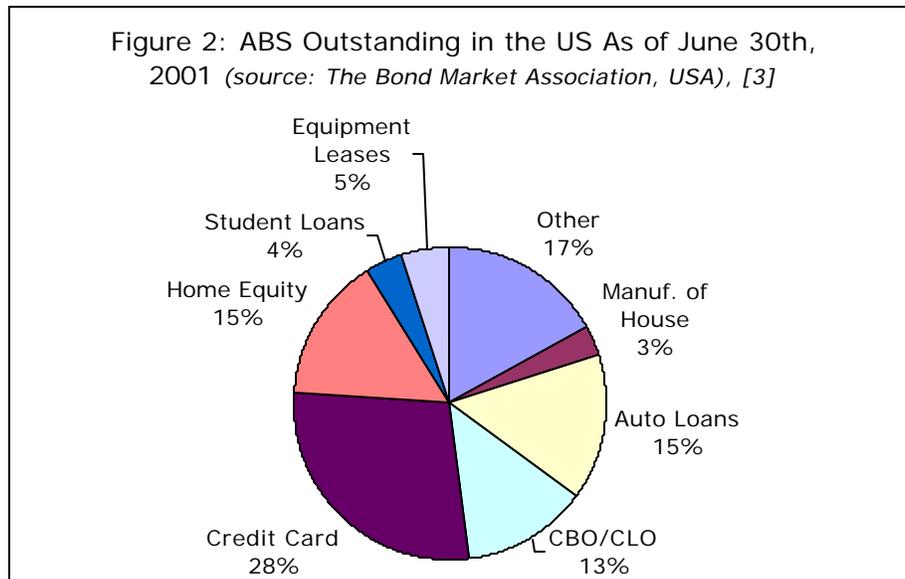
its overall asset exposure [6]. It appears to be only a matter of time before other Public Financial Institutions merge with other banks. Such mergers would result in the need for more CDOs in the foreseeable future.

Current Securitization activity in India

To analyze the potential of securitization India, we split the securitization market into the following four broad areas:

Asset Backed Securities (ABS)

Asset backed Securities are the most general class of securitization transactions. The asset in question could vary from Auto Loan/Lease/Hire Purchase, Credit Card, Consumer Loan, student loan, healthcare receivables and ticket receivables to even future asset receivables. The split of outstanding ABS in the US is given in Figure 2.



In the Indian context, there has been moderate amount of activity on the Auto Loan securitization front. Companies like TELCO, Ashok Leyland Finance, Kotak Mahindra and Magma Leasing have been securitizing their portfolio of auto loans to buyers like ICICI and Citibank over the past 2-3 years, with several of the recent transactions rated by rating agencies like CRISIL and ICRA. While many of the deals are bilateral portfolio buyouts, ICICI has used the SPV structure⁴ and placed the issuance privately to corporate investors and banks.

In April last year, Global Tele-Systems Ltd. raised approximately USD 32 million by securitizing the future receivables of its consumer telecom business to an SPV named Integrated Call Management Centre. Tata Finance was the sole investor in the pass-through certificates issued by the SPV.

⁴ A revocable trust (SPV) purchases assets from the Originator and issues Pay Through Certificates to investors.

One of the first publicized structured finance transactions in India was the Rs. 4.09 billion non convertible debenture program by India Infrastructure Developers Ltd (IIDL), an SPV set up for building and operating a 90 MW captive co-generation power plant for IPCL (March, 1999). IIDL raised finances on the BOLT (Build Operate Lease Transfer) model on the strength of its future cash flows from IPCL and limited support from L&T. The transaction was rated AA- (SO) by CRISIL.

ICICI has done several bilateral asset backed securitization deals including securitizing DOT (Department of Telegraph) receivables from Sterlite Industries and Usha Beltron.

While the activity in the ABS market is picking up in India, the number of investors for securitized paper is very limited. In the absence of a Securitization Act, there are taxation and legal uncertainties with the securitization vehicle. In India, transfer of secured assets as required for securitization, can attract a stamp duty as high as 10% in some states precluding transaction possibilities. With favorable legislation and taxation regime, the ABS market in India can hope to see a lot of activity in future.

Mortgage Backed Securities (MBS, RMBS, CMBS)

As we discussed above, MBS constitutes about 76% of the securitized debt market in the US. In contrast, the MBS market in India is nascent - National Housing Bank (NHB), in partnership with HDFC and LIC Housing Finance, issued India's first MBS issuance in August 2000⁵.

The potential of MBS in India, however, is huge. With NHB actively looking towards the development of a Secondary Mortgage Market (SMM) in the country [2], the MBS market in India could soon overtake the other securitization transactions in the country. An MBS market can help small HFCs with good origination capabilities and limited balance sheet strength in staying profitable and concentrate on the housing loan origination. The most important roadblocks for MBS in India are lack of mortgage foreclosure norms and the high incidence of stamp duty for assignment of mortgage necessary for securitization.

Collateralized Debt Obligations (CDO, CLO, CBO)

In this era of bank consolidations, CDOs can help banks to proactively manage their portfolio. CDOs can also help banks in restructuring their stressed assets. ICICI made an aborted attempt to do a CBO issuance in August 2000. The CDO market in India is, however, likely to grow slowly owing to its complexities. The taxation and accounting treatment for CDOs needs to be clarified.

Asset Backed Commercial Paper (ABCP)

Asset Backed Commercial Paper (ABCP) is usually issued by Special Purpose Entities (ABCP Conduits) set up and administered by banks to raise cheaper finances for their clients⁶. ABCP conduits are usually ongoing concerns with new CP issuances taking out the previous ones. Apart from legal requirements, an active ABCP market requires a large number of investors who understand the instrument and have

⁵ The deal size was Rs. 10.35 billion comprising 11,106 individual housing loans HDFC and LIC Housing finance Ltd.

⁶ An ABCP conduit issues commercial paper to finance the purchase of assets ranging from credit card, auto and trade receivables to CBO and CLOs.

appetite. India's securitization market may not be mature currently for instruments like ABCPs.

The Obstacles & Policy recommendations

Lack of appropriate legislation

As we discussed earlier, there are no laws specially governing securitization transactions in India. The Government of India constituted a Working Group on Asset Securitization in July 2000. This Working Group submitted a comprehensive draft Securitization Bill to the Government. However, the bill has not been tabled in the parliament yet. A comprehensive securitization Act can give a much-needed thrust to securitization activity in India. The following are the key areas where legislation is required:

a) True Sale (Isolation from bankruptcy of the Originator)

The central idea of a securitization transaction is to isolate the assets of the Originator from Originator's balance sheet and seek a higher credit rating than the Originator's own rating. A key requirement for that is to achieve a "true sale" of the assets to the Special Purpose Entity.

b) Tax neutral bankruptcy remote SPE

The special purpose entity that buys assets from the Originator should be a bankruptcy remote conduit for distributing the income from the assets to the investors. While banks have experimented with company revocable trust and mutual fund structures, no clear vehicle has emerged for performing securitization. This should be addressed by the Securitization act.

c) Stamp Duties

Stamp Duty is a state subject in India. Stamp Duties on transfer of assets in securitization can often make a transaction unviable. While five Indian states have recognized the special nature of securitization transactions and have reduced the stamp duties for them, other states still operate at stamp duties as high as 10% for transfer of secured receivables. The Working Group of RBI has recommended a uniform rate of 0.1% duty on all transactions. The acceptance of these recommendations by other states can boost the securitization activity in India especially in the MBS area.

d) Taxation & Accounting

At present there are no special laws governing recognition of income of various entities in a securitization transaction. Certain trust SPE structures actually can result in double taxation and make a transaction unviable. The Securitization Act, when it comes to force, should address all taxation matters relating to securitization.

Securitization legislation should also specify requirements for off balance sheet treatment for securitization and regulatory capital requirements for Originator and Investors.

e) Eligibility

Only recently Mutual funds have been allowed to invest in PTCs. The government should lay down norms governing investment eligibility for various securitization instruments.

Debt market

Lack of a sophisticated debt market is always a drawback for securitization for lack of benchmark yield curve for pricing. The appetite for long ended exposures (above 10 years) is very low in the Indian debt market requiring the Originator to subscribe to the bulk of the long ended portion of the financial flows. The development of the Indian debt market would naturally increase the securitization activity in India.

Lack of Investor Appetite

Investor awareness and understanding of securitization is very low. RBI, key drivers of securitization in India like ICICI and Citibank and rating agencies like CRISIL and ICRA should actively educate corporate investors about securitization. Mandatory rating of all structured obligations would also give investors much needed assurance about transactions. Once the private placement market for securitized paper gathers momentum, public retail securitization issuances would become a possibility.

Conclusions

The securitization market in India, though in its infancy, holds great promise especially in the MBS area. While more complex securitization transactions and public issuance of securitized paper are still a distant dream, appropriate legislation and investor education can give the securitization market in India a much-needed thrust.

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