UPDATE ON INDIAN SECURITISATION MARKET

Issuance volume grows 15% in FY2012; regulatory guidelines could lead to decline in volumes going forward

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Summary

Issuance volume in the Indian securitisation market was Rs. 36,603 crore[1] in FY2012[2], a growth of 15% over the previous fiscal. The increase in volume—following a continuous decline for three years—was on account of a 26% rise in securitisation[3] of retail loans (both Asset-Backed Securitisation or ABS, and Residential Mortgage-Backed Securitisation or RMBS, cumulatively).

As per the 'Master Circular by the RBI for Lending to Priority Sector' released in July 2011, loans by banks to NBFCs no longer qualify as Priority Sector Lending (PSL); post this change in regulation there was only one major way in which banks could meet their shortfall in priority sector lending targets, viz., acquisition of compliant portfolios from NBFCs. On the other hand, Originators' (read NBFCs) motive in entering into these transactions was a finer pricing, capital relief[4] and tenure-matched funding, apart from keeping open an alternate fund-raising channel. This led to a rise in transactions involving bilateral assignment of retail loan pools—mainly including loans to Small and Medium Enterprises (SMEs) or Small Road Transport Operators (SRTOs) and micro credit—especially during the last quarter of the year. Bilateral assignments—accounting for around 75% of ABS and RMBS volume in India—continued to be the preferred route relative to conventional securitisation, given that these transactions were not covered by RBI's guidelines of Feb 2006 on securitisation, thus making them less restrictive for Originators[5].

However, going forward, ICRA expects a significant decline in volume of bilateral assignment transactions given that the RBI Guidelines on Securitisation issued in May 2012 prohibit stipulation of credit enhancement for assignment transactions, thus exposing the purchasing banks to the entire credit risk on the assigned portfolio. Nevertheless, fundamentally, the banks' need to meet PSL targets would continue, which could going forward be met—at least partly—through the securitisation route, wherein credit enhancement is permitted. However, the deterrents to a widespread shift to securitisation are two-fold—high capital charge for Originators[6] and impact of mark-to-market for the Investing Banks. Another key constraint presently is the ambiguity on the taxation of PTCs, a matter which is presently sub-judice. Pending clarity on the issue, Mutual Funds—as well as several banks—are staying away from making fresh investments in PTC instruments. Additionally, RBI's adoption of the proposals of the Nair committee on Priority Sector Lending (report submitted in February 2012) would be a key regulatory guideline to watch out for.

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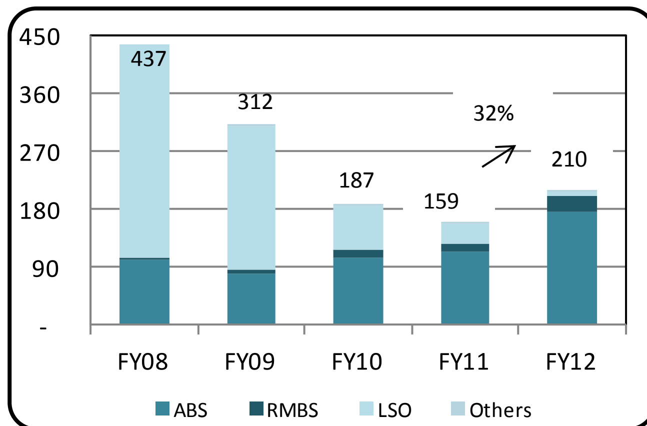
[1] 1 crore = 10 million = 100 lakh
[2] Financial Year 2012, i.e. April 1, 2011 to March 31, 2012
[3] For the purpose of the present note, 'securitisation' includes rated 'bilateral assignment' transactions, unless stated otherwise in specific contexts
[4] Capital relief was an important motive prior to the May 2012 guidelines, as discussed later in this note
[5] Treatment of credit enhancement being the main factor
[6] Credit enhancement offered is to be reduced from capital as per Feb 2006 guidelines

Indian Securitisation Market

ABS continues to form a major part of transactions in FY2012

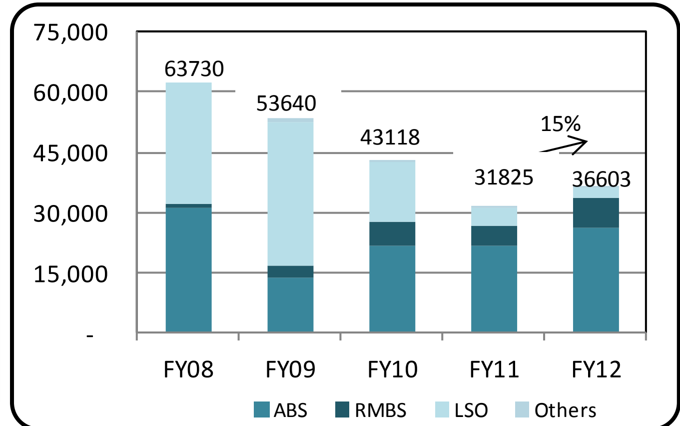
During FY2012, the securitisation market in India grew by 15% over the previous year, in value terms. The number of transactions was also 32% higher in FY2012 than in the previous fiscal. The number and volume of retail loan securitisation (both ABS and RMBS together), was the highest in FY2012 compared to previous fiscals, while the LSO issuance was the lowest ever.

Figure 1: Trend in Securitisation - by number



Source: ICRA's estimates

Figure 2: Trend in Securitisation - by value, in Rs. crore



Source: ICRA's estimates

Table 1: Trend in SF Issuances - by value, in Rs. crore

	FY2009		FY2010		FY2011		FY2012	
	Amount	**Share**	**Amount**	**Share**	**Amount**	**Share**	**Amount**	**Share**
ABS	13,581	25%	21,497	50%	21,819	69%	26,071	71%
RMBS	3,291	6%	6,254	14%	5,029	16%	7,680	21%
Total Retail Securitisation	**16,872**	**31%**	**27,751**	**64%**	**26,848**	**84%**	**33,751**	**92%**
LSO[7]	35,608	66%	14,581	34%	4,441	14%	2,217	6%
Others	1,160	2%	787	2%	536	2%	635	2%
Overall total	**53,640**	**100%**	**43,118**	**100%**	**31,825**	**100%**	**36,603**	**100%**
Growth	*(16%)*		*(20%)*		*(26%)*		*15%*	

Source: ICRA's estimates

As can be seen from table 1, given the increase in both the ABS and RMBS products coupled with a reduction in LSO issuance, the overall share of retail loan securitisation increased during FY2012. The average deal size was lower in FY2012 compared to the previous two fiscals, mainly due to the greater share of microfinance loan[8] pools.

LSO issuance has been witnessing a sharp decline since H2 of FY2011. LSO transactions were largely short-term in nature and the Originator would typically disburse the loan with the specific intention of securitising it soon after the disbursement. RBI's draft guidelines issued in the first quarter of FY2011, specially the requirement of Minimum Holding Period (MHP) of 9 to 12 months, created a potential interest rate risk for the Originator and adversely affected the LSO issuance volume[9]. Moreover, the lacklustre demand from mutual funds (MFs)—the key investor segment in LSOs in the past—owing to low secondary market liquidity for PTCs, and the prohibition on investment by liquid funds in debt with tenure longer than 91 days further impacted LSO issuance volume.

[7] Securitisation of individual corporate loans or loan sell-off (LSO)
[8] Loans smaller than Rs. 30,000, typically given to women below poverty line for income generating purpose.
[9] nevertheless the guidelines are at a draft stage and some issuances did happen

Direct Assignment continues to dominate; Preference for par structures continues to grow

After the issuance of the securitisation guidelines in 2006, there has been a high preference for 'direct or bilateral assignment' of retail loan pools, i.e., direct sale of a selected loan pool by the 'Originator' to the 'Purchaser' (or Assignee) together with limited credit support, as against securitisation which involves the sale of receivables to a special purpose vehicle (SPV) and issuance of Pass Through Certificates (PTCs) by the SPV. Over the past four years i.e. since FY2009, about 75-80%[10] of the total number of ABS and RMBS transactions has been in the nature of direct assignment transactions, wherein no specific instrument is issued even as the assignee payouts are rated.

The broad structure of direct assignment transactions is similar to that of regular ABS or RMBS transactions, except for the absence of the issuance of any instruments like pass-through certificates (PTCs). The pool receivables in such cases are assigned directly to the "assignee" or "purchaser". These are accounted for by the purchaser, typically a bank, in its "advances" book (unlike PTCs, which form a part of the bank's investments portfolio). The choice of the route, "direct assignment" or "securitisation" depends largely on Originator / investor preference. For instance, while MFs can invest only in "instruments", banks often prefer to acquire loan portfolios outright, since PTCs—by virtue of them being investments—would need to be marked to market, and loans and advances do not have this requirement. Given that these transactions help towards meeting their PSL targets, during FY2012, Assignees (read Banks) typically provided fine pricing to the Originators (read NBFCs) for the same, which MFs—the other potential investor segment—was generally unable to match. Moreover, from the Originator's point of view, targeting MFs would've required a conventional "securitisation" transaction, involving issuance of PTCs[11], which would require greater capital charge on the credit enhancement[12].

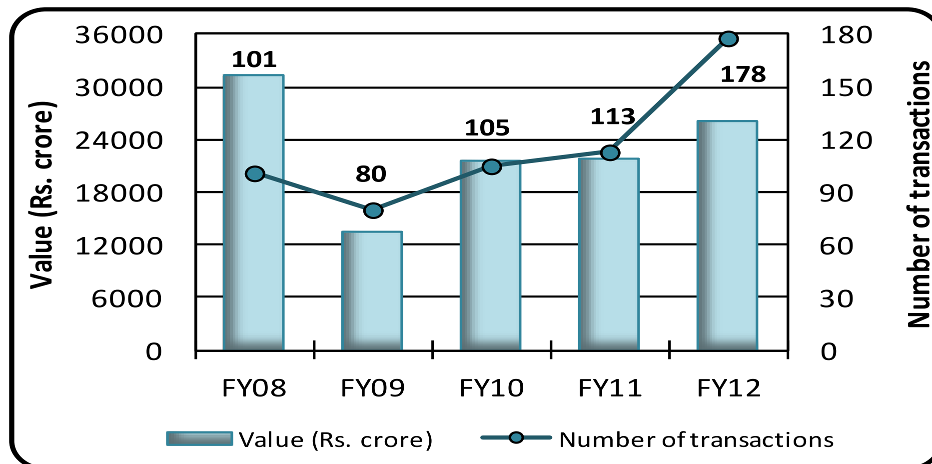
The preference for par structures continued to be high in FY2012; "premium" structures accounted for only 10% of the total number of ABS and RMBS issuance during the year as against 37% and 18% in FY2010 and FY2011, respectively. Most ABS and RMBS transactions in FY2012 had simple structures with a single tranche (while some transactions had two tranches), and the credit enhancement in the structures was primarily in the form of cash collateral. The par structures also had some excess interest spread (EIS) or principal subordination as credit enhancement. RBI's circular of January 2011 notifying banks to consider only the par value of transactions for obtaining priority sector benefit on loans, was also a factor contributing to the preference for "par" structure.

Asset-Backed Securitisation

ABS remains major asset class; number of transactions rise significantly in FY2012

The number of ABS issues increased significantly by 58% in FY2012 to 178 transactions. However, in value terms, the increase was only 19% over FY2011. The average deal size was lower at Rs. 146 crore in FY2012 compared to Rs. 193 crore in FY2011. This was on account of higher number of Microfinance transactions executed in FY2012 at 65 that was about twice the issuance in FY2011 at 34.

Figure 3: Issuance Volumes in Indian ABS Market



Source: ICRA's estimates

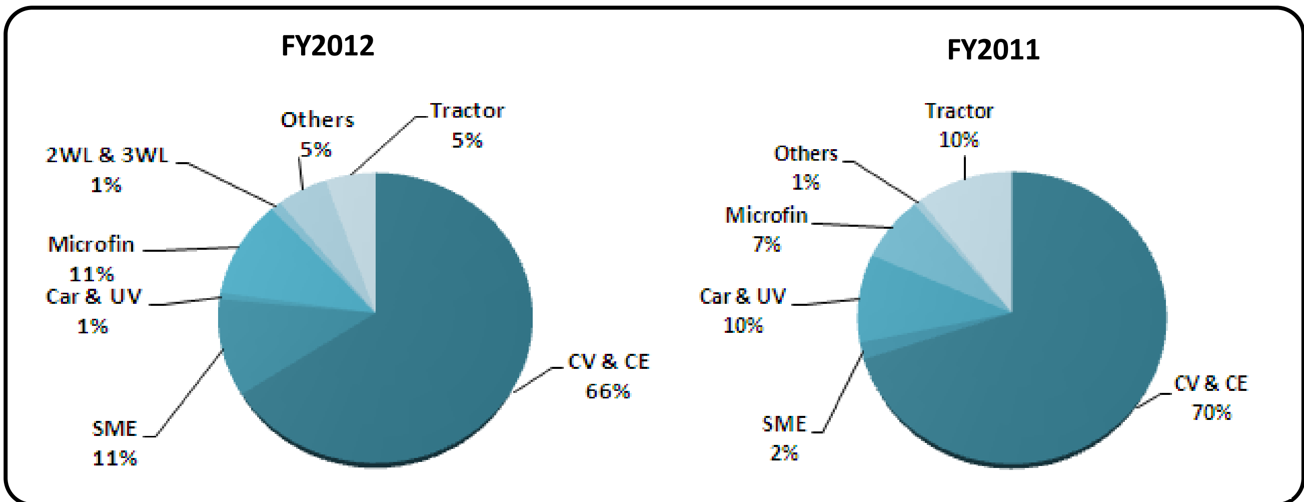
[10] *The share of Direct Assignment transactions was lower at 50%-60% in FY2008 and FY2007 and about 25% in FY2006.*
[11] *Since MFs can't take loan exposures, but can only invest in security instruments*
[12] *As per RBI's guidelines on securitization (Feb 2006), credit enhancement provided for a securitization transaction by the Originator shall be reduced from its capital funds, while the guidelines technically do not cover 'direct assignments'.*

The total number of issuers in the ABS space increased from 23 to 33 as some microfinance entities entered the securitisation (or assignment) market. Shriram Transport Finance Company, SREI Equipment Finance, Indiabulls Financial Services Ltd., Sundaram Finance and Shriram City Union Finance were the largest Originators in FY2012, altogether contributing to over 60% of the total number of ABS issuances. Banks continued to be absent from the securitisation market as Originators (although they continue to be a key investor segment).

Commercial Vehicle (CV) / Construction Equipment (CE) loans continue to dominate ABS space

Given that the key motive for the Assignees to enter into the transactions was mainly to meet PSL targets, the underlying asset categories were those that would qualify as PSL.

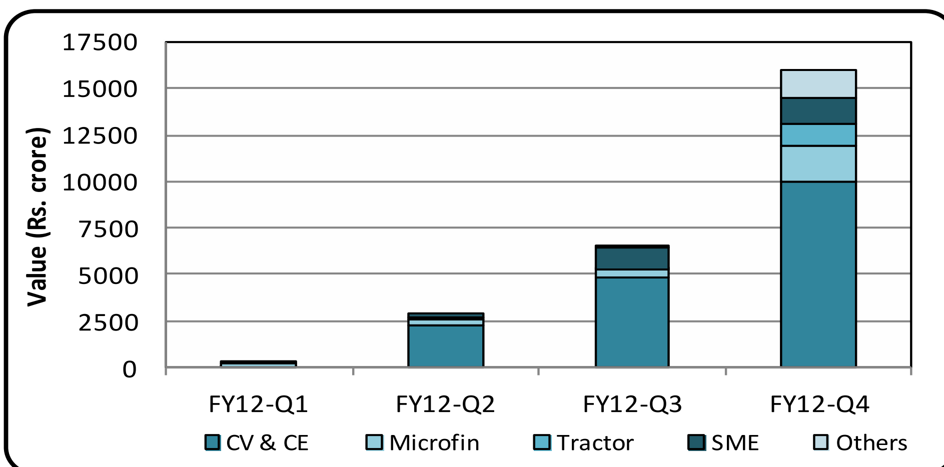
Figure 4: Asset Class-wise Distribution of ABS Pools—FY2012 and FY2011



Source: ICRA's estimates

In FY2012, CV and Construction Equipment (CE) loans continued to be the key asset class accounting for two-thirds of the total ABS volumes. The long and relatively stable track record of CV / CE lending in the country (also demonstrated through good performance of the past pools) and the relatively larger size of CV / CE loan portfolios in the industry have been the key factors for the popularity of this asset segment in securitisation. Microfinance and SME loans, which had a small share in securitisation in the previous year's emerged as the other key loan categories to be securitised accounting for almost 11% each in FY2012 from about 7% and 2% in FY2011. However, there was some securitisation of Two Wheeler loans in FY2012, a segment absent during the previous two years.

Figure 5: Trend in securitisation of different asset class



Source: ICRA's estimates

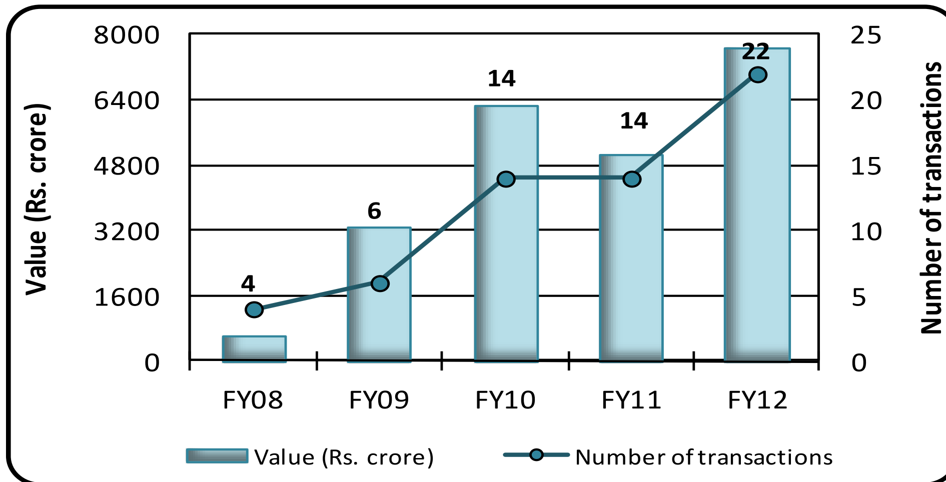
Figure 7 above depicts the asset class-wise composition of securitisation in each quarter of FY2012. As is usually the trend every year, the overall volume in the first quarter—of FY2012—was very low, while the last quarter accounted for the largest share—almost 62% of the total annual volume. Microfinance securitisation picked up significantly in the last quarter, driven by the PSL targets of banks (who were key investors in these transactions).

Residential Mortgage-Backed Securitisation

RMBS issuance grows in FY2012

The number of RMBS issuances increased to 22 in FY2012 along with an increase of 53% in value terms. However, the average deal size marginally reduced to Rs. 349 crore in FY2012 from Rs. 359 crore in FY2011. RMBS segment continued to be highly concentrated with HDFC and Dewan Housing Finance, which together contributed to about 85% of all issuances.

Figure 6: Issuance Volumes in Indian RMBS Market



Source: ICRA's estimates

Despite higher issuances seen in the year, the traditional obstacles to RMBS in India, viz., long tenure of RMBS paper, the lack of secondary market liquidity, high stamp duty on transfer of security, tenure uncertainty, interest rate risk and prepayment risk, continued to hinder the growth of this segment. Nevertheless, regulatory requirements—certain category of home loans qualify as priority sector lending—provide the motive for trading in home loans too. Accordingly, banks were typically the investors in these transactions.

RMBS issued at par value with floating yield to investors

Mortgage loans typically carry floating rate yield, leading to uncertainty of cashflow of such loans—unlike other retail loans wherein the interest rate is fixed. Owing to this feature, together with the potentially higher volatility of prepayment rates in the case of mortgage loans, "par" structures are preferred in the case of RMBS. All the 22 RMBS transactions executed in FY2012 had a par structure.

In FY2012, all ICRA-rated issuances carried variable yield to investors, with such yields linked either to the pool yield or to an external benchmark. In either case, the Originator is able to entirely (or almost) lock in its gross spread with respect to the pool assigned. It has to then manage its credit (given that credit enhancement is provided by the Originator) and operating costs (since the servicing function is also performed by the Originator) so as to achieve a healthy net interest margin. In fact, for many RMBS issuers, the key motivator for such deals is tenure-matched funding (and thus reduced Asset-Liability mismatch) together with a locked-in spread.

Linking floating-rate investor pieces to the yield on the underlying pool is perhaps the best way to mitigate re-pricing risk in the structure. However, the underlying loans in an RMBS pool are linked to the prime lending rate (PLR) of the Originator, and investors are often unwilling to take a call on the movement of the PLR of the Originator or on the change in the pool's internal rate of return (IRR), as these may not necessarily move in tandem with universally accepted benchmarks.

Update on Key Regulatory Changes Impacting Securitisation

Priority Sector status for bank loans to Micro Finance Institutions (MFIs) (May 2011)

RBI's circular issued in May 2011 confirmed that RBI would be the regulator for the microfinance sector. It also clarified that bank credit to MFIs extended from 1 April 2011 will be eligible for Priority Sector classification provided the MFI and the loans meet certain conditions. The conditions that the MFI needs to be compliant with to enjoy the priority sector status are mostly in line with the recommendations of the Malegam Committee released in January 2011. The May 2011 circular notified that the guidelines relating to categorization of (i) investment by banks in securitised assets originated by MFIs and (ii) outright purchase of loan portfolios of MFIs as priority sector advances in the books of the banks would be issued in due course. Nevertheless, it was clarified that fresh assets would qualify for priority sector treatment only if they satisfy the criteria of qualifying assets.

Master Circular by the RBI on Lending to Priority Sector (July 2011)

In this circular, the RBI clarified that the investments made by bank in securitised assets or outright purchase by banks of any loan asset, shall be eligible for classification under the respective categories of priority sector provided the underlying loans qualified as priority sector advances prior to securitisation or sale.

Nair Committee report on re-examining and suggesting revision with respect to Priority Sector classification and related issues (February 2012)

The M.V. Nair Committee set up by RBI, in its report submitted in February 2012, recommended that bilateral assignment of loans and securitisation should continue to be allowed to be classified as priority sector provided the underlying asset is eligible for classification under priority sector advances. Also, it talks of clear due diligence criteria for assets acquired through NBFCs, which is a positive. Moreover, increasing the priority sector targets for foreign banks from 32% to 40% would increase the funding avenues for various entities that want to avail priority sector benefits.

Nevertheless, these benefits have to be seen in the light of—

- Overall cap of 5% of Adjusted net bank credit (ANBC) on priority sector bank lending through non bank financial intermediaries—which includes portfolio buy-outs and investment in securitization instruments
    - Given that several banks, particularly private sector banks have been investing in securitisation or Direct Assignment transactions to meet their PSL targets, this move would have an adverse impact on the buying appetite of banks that were exceeding the 5% cap. This is turn could adversely affect the ability of the Originating NBFCs to securitise their portfolios.
- Proposed interest spread cap of 6% for NBFC-AFCs and 3.5% for HFCs
    - This recommendation is likely to have an impact on securitisation of certain asset classes like Microfinance loans and SME Loans, where the interest spread has been observed to be higher than 6%. Barring a handful of transactions, most microfinance transactions have an interest spread greater than 6% and in some cases the spread has been observed to be higher than 10% also- this is primarily due to high interest rate on the underlying loans, which is typically in the range of 22%-26%.
- Capping of off-balance sheet exposure (of NBFCs) at 35%
    - This is likely to have an immediate bearing on the portfolio of 3-4 large NBFCs that have off balance sheet exposure exceeding 35%.
- Also, the committee's recommendation is to continue to exclude loans against gold jewellery from priority sector advances
    - Hence the attractiveness of this asset class for securitisation is expected to remain low.

Guidelines on Securitisation and Direct Assignment Transactions (May 2012)

The RBI, in May 2012, put out the final guidelines on securitisation and direct assignment of assets by banks. This is the first time the RBI has issued separate guidelines for Direct Assignment transactions. Amongst the important new prescription in the guidelines is the prohibition of credit enhancement for direct assignment transactions. The other key stipulations are a Minimum Holding Period (MHP) for Originators before off-loading the receivables and a Minimum Retention Requirement (MRR) through the tenure of the transaction.

The guidelines are expected to have far-reaching implications on the issuance volumes as well as the nature of the transaction structures adopted. For a detailed discussion on the guidelines and their expected impact, please refer ICRA's report titled "RBI Final Guidelines on Securitisation and Direct Assignment Transactions to Adversely Impact Volumes in the Near Term", released in May 2012.

Income tax authorities' notice for taxation of SPVs

During FY2012, the income tax authorities sent notices to trustees of several securitization transactions—which the trustees in turn passed on to the investors, i.e., mutual fund houses—asking them to pay tax on income generated through pass through certificates (PTCs). Following this move, the MFs filed petitions in the Bombay HC, seeking a relief from the tax claim and attachment of their accounts—given that MFs are exempt from income tax. The Bombay High Court passed a stay order on the I-T department notice till the commissioner I-T disposes off the appeal filed by the mutual funds against its notice. Though the matter is sub-judice, the fund houses have been skeptical about investing in securitised instruments till the matter is sorted out. Securitisation transactions in India basically operate on the premise that the beneficiaries of the SPV—typically a trust—will offer the income earned from the investment to tax, and thus the income should not be taxed at the level of the trust. The IT department's stance effectively challenges this premise and thus, a resolution to this issue could be an important factor for determining the future of securitisation going forward. Most market participants are of the view that the most immediate and severe obstacle to securitization is this unresolved issue of taxation of the securitization SPV.

Summary and Outlook

Though retail loan securitisation improved in FY2012, the issuance volume in India continues to remain subdued and concentrated among few Originators. Around 75% of the market in FY2012 was essentially bilateral loan pool trading, driven by the economics of priority sector lending targets. It follows that the investor segment is largely banks—mainly private sector and foreign banks. Mutual Funds have mostly been absent from the securitisation market for a variety of reasons, the latest being the unresolved issue of income tax authorities' claim on taxing the income from securitised instruments.

The final guidelines on securitization and bilateral assignments are expected to result in a significant decline in volume of bilateral assignments given the prohibition on credit enhancements by Originators in these transactions[13]. The other key factors that will largely shape the course of securitisation of retail asset loans going forward are the extent to which the Nair committee recommendations are adopted and also the legal stance on the taxation of PTCs. In addition to regulatory prescriptions, the pace of growth in loan book size among key players would continue to be a basic determinant of level of securitisation activity.

[13] *For a detailed discussion on the guidelines and their expected impact, please refer ICRA's report titled "RBI Final Guidelines on Securitisation and Direct Assignment Transactions to Adversely Impact Volumes in the Near Term", released in May 2012.*

Notes

- This report is based on publicly available information on domestic structured finance transactions. While reasonable care has been taken to ensure that the information herein is true, ICRA makes no claim of the same being exhaustive or comprehensive.
- For the purpose of this report, the estimate of the size of the structured finance market is based on the rated retail/corporate loan securitisation deals (both bilateral assignment deals and multi-investor market deals). Unrated or privately rated transactions as well as various on-balance-sheet obligations have not been considered.
- Several bilateral loan pool assignment transactions may have been rated on a private basis; these have been excluded from the estimates made in this report. The volume of such deals is difficult to estimate, but could be substantial.
- In the case of some of the mixed ABS pools not rated by ICRA, data on the precise shares of the different asset classes were not available. The same has been estimated on the basis of the typical asset category-wise distribution of the various past pools of the same Originator.
- An LSO (or loan sell-down) is a relatively simple transaction wherein the Originator (most often a private sector or foreign bank, or NBFC) securitises the receivables from a single corporate loan (typically, a loan to a home finance company, or NBFC, or a mid-sized corporate). In most cases, there is no external credit enhancement and the credit rating of the PTCs reflects the credit quality of the underlying borrower. Often, the loan is originated with the specific intention of securitising it, sometimes within a day of disbursement. Thus, the Originator's funds are locked in for a minimal period and the gain on securitisation is akin to non-fund-based income for the Originator. Also, in the absence of Credit Default Swaps (CDS), this route enables lenders to manage their exposure limits on borrowers. Borrowers often prefer the loan route to the bond route of raising funds, since the latter requires greater disclosure and documentation, thus often being more time-consuming. For investors, PTCs backed by single loans are simple short-tenure instruments, akin to corporate bonds, with no prepayment risk and tenure uncertainty (unlike ABS and RMBS).

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