



UPDATE ON INDIAN SECURITISATION MARKET

Issuance volume shrinks further by 29% in FY2011

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Summary

Issuance volume in the Indian securitisation market fell by 29% in FY2011¹ over the previous fiscal to Rs. 30,825 crore². While securitisation³ of retail loans (both Asset-Backed Securitisation or ABS, and Residential Mortgage-Backed Securitisation or RMBS, cumulatively) was slightly lower by about 6%, the drop in overall volume was mainly owing to Single corporate loan securitisations [also known as Single Loan Collateralised Loan Obligations (CLOs) or Loan Sell-Offs (LSOs)] falling out of favour. LSOs—the largest product class in FY2009, dwindled down to a trickle in FY2011, the reduction being mainly a fall-out of draft regulatory guidelines.

As expected by ICRA⁴, pursuant to the draft guidelines of the Reserve Bank of India (RBI) issued in first quarter of FY2011, regarding the minimum holding period (MHP) and minimum retention requirement (MRR), LSO transactions were adversely affected, and almost stopped in the second half of the previous fiscal. Regulatory factors like “priority sector lending” (PSL) targets for banks—and the resultant acquisition of such loan pools from non-banking finance companies (NBFCs)—continued to be the key motivator for ABS and RMBS transactions. Microfinance loan securitisation saw a surge in the second half of FY2011 as MFIs found it difficult to obtain alternate source of funding and investors (mainly banks) took exposure in these transactions mainly driven by the motive of fulfilling their PSL targets.

Going forward, ICRA expects the issuance volumes to remain modest, in the backdrop of uncertainty regarding the final regulatory prescriptions and subdued investor demand. Nevertheless, regulatory factors such as PSL targets (for banks) would continue to drive trading in certain loan assets. Similarly, the final shape of the guidelines on MHP and MRR proposed by the RBI for securitisation and the applicability of the same for bilateral transactions are expected to influence issuance volumes. SEBI’s recent action of issuing the model Listing Agreement for Securitised Debt Instruments is another step towards bringing in transparency and improving secondary market liquidity for these instruments.

¹ Financial Year 2011, i.e. April 1, 2010 to March 31, 2011

² 1 crore = 10 million = 100 lakh

³ For the purpose of the present note, ‘securitisation’ includes rated ‘bilateral assignment’ transactions

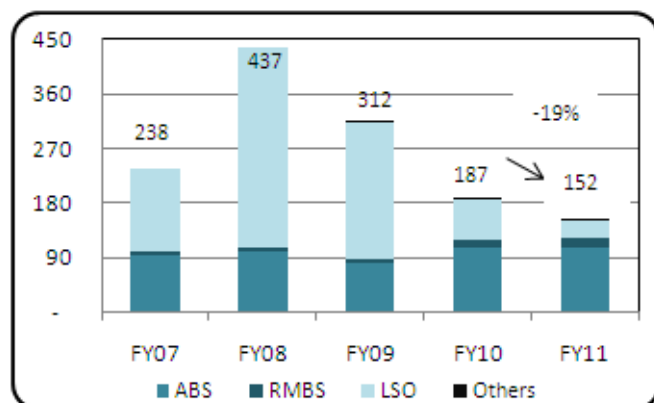
⁴ Please refer ICRA’s Update on Indian Structured Finance Market, April 2010

Indian Securitisation Market

ABS continues to form a major part of transactions in FY2011

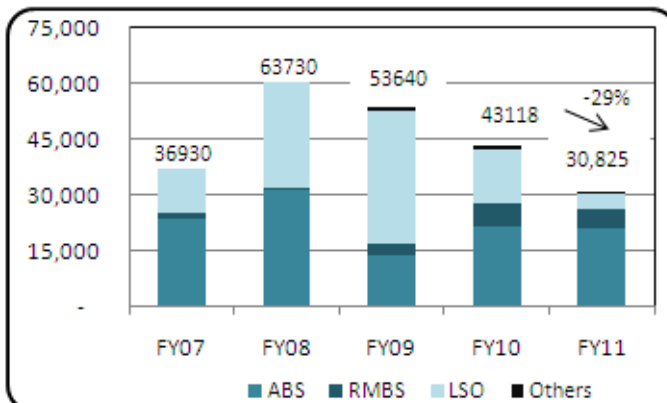
Securitisation market in India slowed down by a further 29% in value terms during FY2011. The number of transactions in FY2011 was almost 20% lower than that in the previous fiscal. Though there was a small decline in retail loan securitisation (both ABS and RMBS), it was the drastic reduction in the LSO issuance that contributed to the sharp slowdown in the overall securitisation market.

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

	FY2008		FY2009		FY2010		FY2011	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share
ABS	31,323	49%	13,581	25%	21,497	50%	20,920	68%
RMBS	588	1%	3,291	6%	6,254	14%	5,029	16%
Total Retail Securitisation	31,911	50%	16,872	31%	27,751	64%	25,948	84%
LSO ⁵	31,819	50%	35,608	66%	14,581	34%	4,341	14%
Others ⁶	--	--	1,160	2%	787	2%	536	2%
Overall total	63,730	100%	53,640	100%	43,118	100%	30,825	100%
Growth	73%		(16%)		(20%)		(29%)	

Source: ICRA's estimates

As can be seen from table 1, notwithstanding the decline in both the ABS and RMBS product, the overall share of retail loan securitisation increased during FY2011. The average deal size was lower in FY2011, mainly due to the greater share of the microfinance loan pools.

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

The securitisation market in India continues to be dominated by the '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. During FY2009 and FY2010 as well as in FY2011, about 80%⁷ of the total number of ABS and RMBS transactions has been in the nature of direct assignment transactions, wherein no specific instrument was issued even as the assignee payouts were rated.

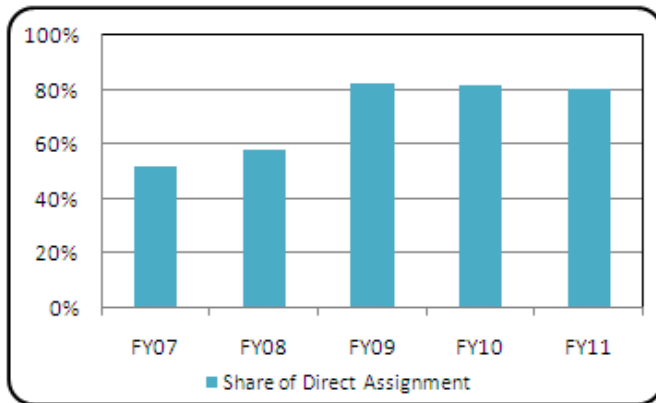
The broad structure of direct assignment transactions is similar to that of regular ABS or RMBS transactions, except for the absence of the issuance of any instruments like pass-through certificates (PTCs). The pool receivables in such cases are assigned directly to the "assignee" or "purchaser". These 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).

⁵ securitisation of individual corporate loans or loan sell-off (LSO)

⁶ A lease receivable transaction originated by Indian Railway Finance Corporation (IRFC) was executed in FY2009, FY2010 and FY2011.

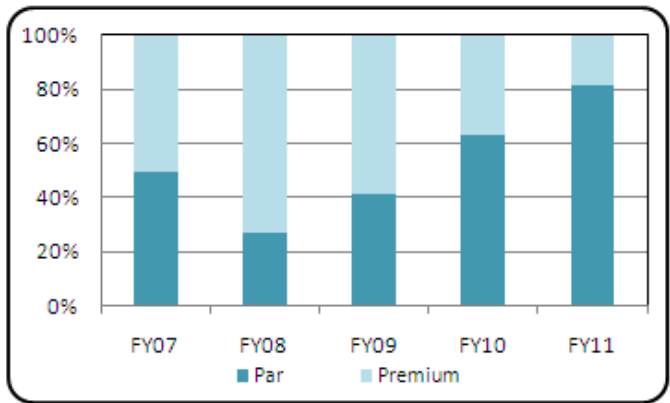
⁷ During FY2011, in value terms, bilateral assignments accounted for about 90% of the issuances

Figure 3: Share of Direct Assignment transactions



Source: ICRA’s estimates

Figure 4: Share of par/premium structures in transactions



Source: ICRA’s estimates

The choice of the route, “direct assignment” or “securitisation” depends largely on 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. Moreover, from the Originator’s point of view the yields on such transactions are also typically very attractive. Nevertheless, during FY2011, with the introduction of the base rate regime, the base rate of the Assignee Bank acted as the floor for the transaction yield. To a certain extent, this could have also acted as an impediment for some potential assignment transactions, wherein the Originator would have preferred to execute the transactions at an even lower Assignee yield.

The preference for par structures continued to rise in FY2011; “premium” structures accounted for only 18% of the total number of ABS and RMBS issuance during the year as against 37% and 58% in FY2010 and FY2009, respectively. Most ABS and RMBS transactions in FY2011 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. With the RBI releasing a circular in January 2011 notifying banks to consider only the par value of transactions for getting priority sector benefit on loans, the preference for premium structure is expected to decline significantly for investment in securitisation made for getting priority sector benefits.

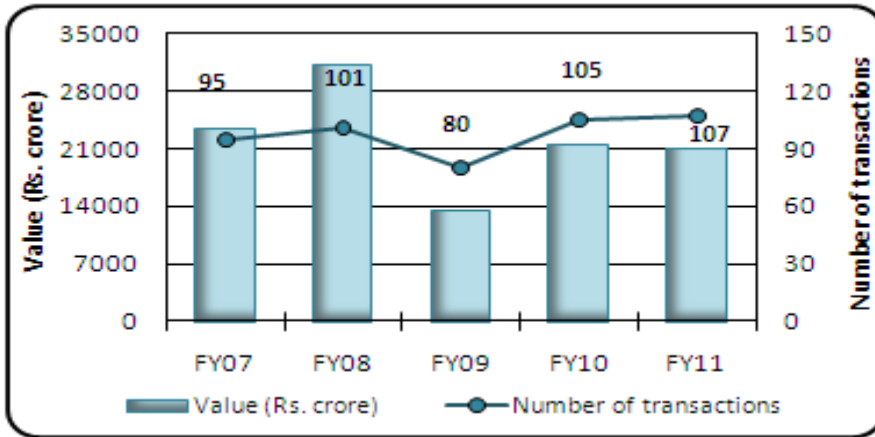
Asset-Backed Securitisation

ABS remains major asset class; volumes remain flat in FY2011

In FY2011, the number of ABS issues increased marginally by 2%, however, in value terms, there was a marginal decline by 3% when compared to that in FY2010. The average deal size was lower at Rs. 196 crore in FY2011 compared to Rs. 205 crore in FY2010. In April 2010⁸, RBI released draft guidelines requiring Originators to hold loans on their books for a certain minimum period (Minimum Holding Period or MHP) before securitising; and to continue to retain a prescribed portion of the exposure (Minimum Retention Requirement or MRR) on their books post-securitisation. The draft guidelines—applicable to conventional securitisation transactions but not to bilateral assignments—were a further dampener for transactions carried out through the PTC route, which had already been on a decline partly owing to regulatory prescriptions, (viz. any credit enhancement provided by the Originator has to be charged against capital, also no portion of credit enhancement can be released till the end despite the amortising nature of the underlying receivables pool) and partly to low demand from investors. Other factors that could have partly contributed to the slowdown in ABS volume during FY2011 were NBFCs’ relatively better access to other funding sources, and several large players being keen on growing their portfolio rather than churning it.

⁸ These guidelines were applicable to Banks; in June 2010, RBI released a similar set of guidelines applicable to NBFCs

Figure 5: Issuance Volumes in Indian ABS Market



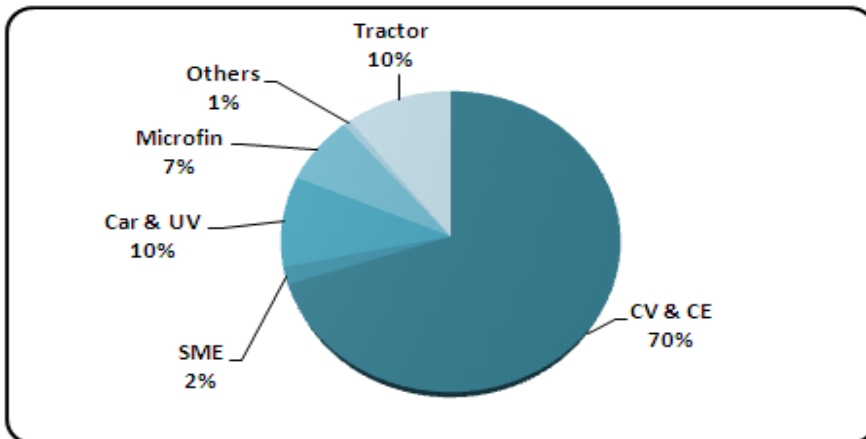
Source: ICRA's estimates

The total number of issuers in the ABS space however, increased from 21 to 23 as some new microfinance players entered the securitisation (or assignment) market. Shriram Transport Finance Company, Tata Motors Finance, SREI Equipment Finance, Mahindra & Mahindra Finance, Magma Fincorp and Reliance Capital were the key Originators in FY2011. Banks continued to be absent from the securitisation market as Originators (although they continue to be a key investor segment).

Commercial Vehicles (CV) continue to dominate ABS space

The choice of the asset category to be securitised depends on factors like the category-wise mix of the Originator's business, regulatory issues, risk weights, and the credit enhancement levels stipulated.

Figure 6: Asset Class-wise Distribution of ABS Pools—FY2011

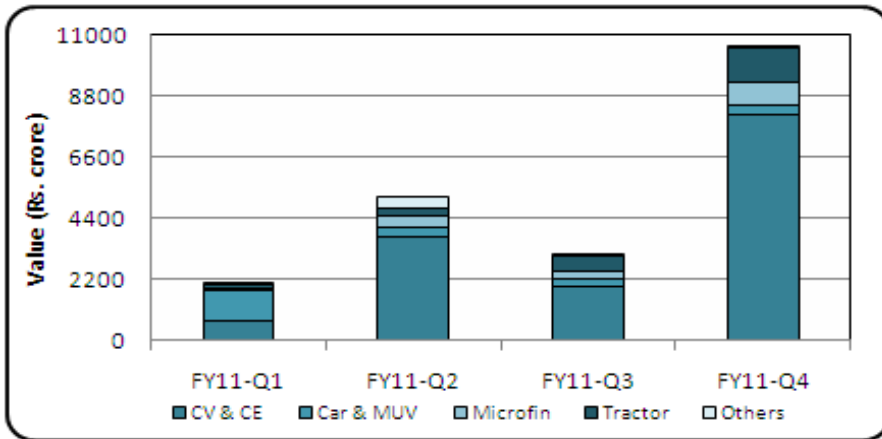


Source: ICRA's estimates

In FY2011, CV and Construction Equipment (CE) loans continued to be the key asset class accounting for almost 70% of the total ABS volumes in FY2011, with Cars and Utility Vehicles (UV) loans being the other key loan category to be securitised. The share of microfinance and tractor loans increased from 3% and 4% in FY2010 to 7% and 11%, respectively in FY2011. With most banks and NBFCs being increasingly conservative on extending personal loans, there was no securitisation of personal loans during the last two years. Also securitisation of loans against gold jewellery that was prevalent in FY2010 was absent in FY2011⁹.

⁹ Nevertheless, ICRA believes that bilateral assignment of pools of loan against gold continues on an unrated basis, albeit on a smaller scale

Figure 7: Trend in securitisation of different asset class



Source: ICRA’s estimates

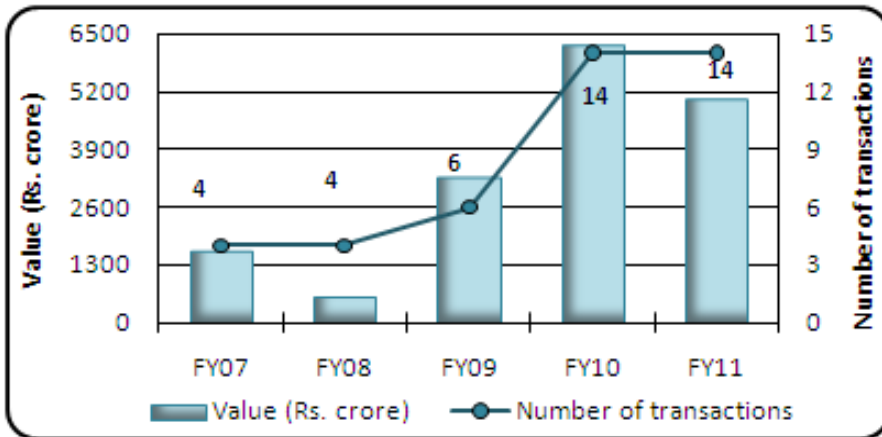
Figure 7 above depicts the asset class-wise composition of securitisation in each quarter of FY2011. As is usually the trend every year, the overall volume in the first quarter—of FY2011--was very low, while the last quarter accounted for the largest share—almost 50% of the total annual volume. Microfinance issuance picked up significantly in the last quarter, driven by the PSL targets of banks (who were key investors in these transactions), and also the fact that alternate sources of funding—such as term loans and NCDs—dried up for these Originators, post the crisis in the Indian microfinance sector.

Residential Mortgage-Backed Securitisation

RMBS issuance continues to remain low in FY2011

The number of RMBS issuances remained flat at 14 in FY2011. However, the issuance volume declined by 20% in FY2011 when compared to the previous fiscal with the average deal size reducing from Rs. 447 crore in FY2010 to Rs. 359 crore in FY2011. RMBS segment continued to be highly concentrated among few Originators; HDFC Limited alone contributed to 70% of all issuances (10 of the 14 RMBS transactions).

Figure 8: Issuance Volumes in Indian RMBS Market



Source: ICRA’s estimates

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. Except for one, all the transactions in FY2011 involved direct bilateral assignment of residential mortgage loans.

RMBS issued at par value with floating yield to investors

Given the volatility in prepayment rates, and the possibility of “conversion”¹⁰ of interest rate in mortgage loans, RMBS issuers prefer “par” structures. All the 14 RMBS transactions executed in FY2011 had a par structure.

In FY2011, 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.

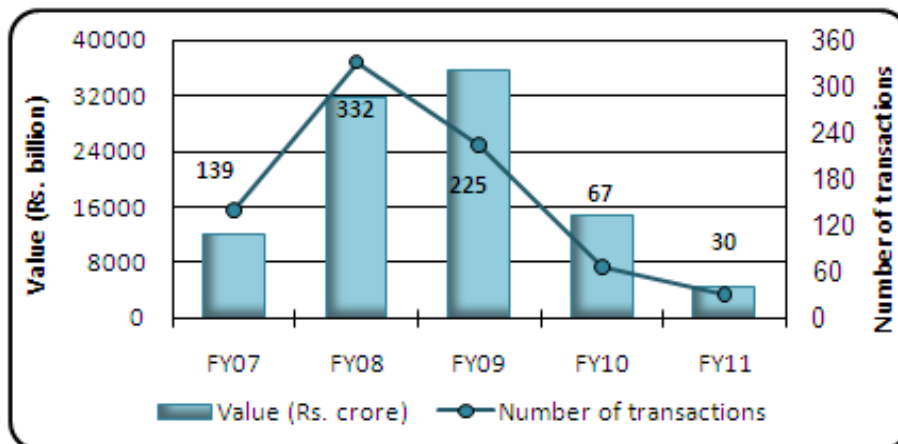
Linking floating-rate investor pieces to the yield on the underlying pool is perhaps the best way of mitigating re-pricing risk in the structure. However, the underlying loans in an RMBS pool are linked to the prime lending rate (PLR) of the Originator, and investors are often unwilling to take a call 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.

Corporate Loans Securitisation

LSO issuance dries up in FY2011 following new regulatory guidelines

The number of individual corporate loans securitised in FY2011 was less than half of that in FY2010, while in value terms it was less than a third. In FY2011, the 30 LSO transactions amounted to Rs. 4,341 crore, the lowest since FY2006. Consequently, LSO’s share in the total securitisation activity dipped to around 17% in FY2011, much lower than the 34% share it had during the previous year. There have been no multi-credit Collateralised Debt Obligation (CDO) transactions since FY2005.

Figure 9: Issuance Volumes in Indian LSO Market



Source: ICRA’s estimates

Of the 30 LSO issuances during the year, 27 were in the first half. 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 MHP of 9 to 12 months, created a potential interest rate risk for the Originator and adversely affected the LSO issuance volume¹¹. Moreover, the lackluster demand from mutual funds—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.

¹⁰ Conversion refers to the market practice of allowing the borrower to reprice the loan from a “fixed” rate to a “floating” rate or vice versa, or lower the spread applicable on the loan; such re-pricing while not being covered by the original terms of the loan, is allowed by the lender typically because of competitive pressures, and usually against a “conversion premium”.

¹¹ nevertheless the guidelines are at a draft stage and some issuances did happen

Update on Key Regulatory Changes

Draft guidelines issued on minimum lock-in period and minimum retention for securitisation exposures (April 2010 for banks and June 2010 for NBFCs)

In continuation with the proposal made in its Annual Policy statement of April 2009, the RBI came out with draft guidelines—along with a discussion paper—on MHP and MRR for securitisation of assets by banks in April 2010. Subsequently similar guidelines on MHP and MRR for securitisation of assets by NBFCs were released in June 2010. These draft guidelines are aimed at ensuring Originators do not compromise on due diligence of the assets generated for the purpose of securitisation, curbing the “originate-to-securitise” business model, and bringing in greater alignment of interest between the issuers of and investors in the securitised paper.

At present these guidelines are in the draft stage. The final shape of the guidelines on securitisation (and bilateral loan pool assignments) by banks and NBFCs will have a crucial impact on issuance volumes, especially of short-term loans.

Supreme Court decision regarding transfer of debt (September 2010)

In January 2009, in a case relating to assignment of a non-performing loan, the Gujarat High Court had passed a judgment that disallowed the trading of loans between banks. The High Court ruled that such trading was in violation of the Banking Regulation Act of 1934 and that it would only recognise transfers that occurred under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

In September 2010, the Supreme Court of India set aside the Gujarat High Court order and held that the transfer of debts between banks is legal under the Banking Services Regulation Act, 1949. This ruling by the Supreme Court clears the air on securitisation and loan sale deals in India and provides a relief to banks who can now transfer their debts to other lenders.

Malegam Committee Recommendations for MFIs (January 2011)

The Malegam Committee was set up by the RBI to investigate the various issues pertaining to and practices being followed by MFIs in India. The Malegam Committee, in its report submitted in January 2011, has recommended amongst other things, putting a cap on interest rates, limiting the number of loans taken by borrowers and so on. If the recommendations are accepted by the RBI, then the immediate impact on loans already extended, and on securitised assets is uncertain.

The report also recommends that MFIs that comply with the recommendations should continue to enjoy priority sector lending status. Even though the continuation of priority sector lending status is a positive for MFIs and for securitisation of their assets to banks, the ability of MFIs to comply with the recommendations could be a challenge in the short to medium term.

RBI classification of priority sector loans by banks (January 2011)

In January 2011, RBI notified banks to take into consideration only the par/ nominal value of loans for getting priority sector benefit on such loans. The premium paid (difference between net present value of loans discounted at rate of lending by banks and value of loans) cannot be considered as it leads to overstating of priority sector loans. Given these guidelines, ICRA believes the preference for premium structure should come down significantly for investment in securitisation made for getting priority sector benefits.

RBI classification for loan against Gold Jewellery (February 2011)

The RBI issued a circular on “Classification of loans against gold jewellery” wherein it has stated that loans sanctioned to NBFCs or investments made by banks in securitised assets originated by NBFCs where the underlying assets are loans against gold jewellery, will not be treated as exposure to the agricultural sector. Given the lack of agricultural status for these loans, the pace of securitisation of these loans may slow down as most securitisations of this asset class was done for getting agricultural sector benefit. However, if these loans can get classified under priority sector lending other than agriculture for banks, then there may still be some interest in securitising such loans.

SEBI Guidelines on Listing Agreement for Securitised Debt Instruments (March 2011)

SEBI had finalised the guidelines for listing and trading of PTCs in May 2008. These regulations provide a framework for issuance and listing of securitised debt instruments by a special purpose distinct entity (SPDE). SEBI has now in March 2011, come out with the Listing Agreement for Securitised Debt Instruments. The listing agreement provides for disclosure of pool level, tranche level and select loan level information. Greater transparency should improve investor sentiment and confidence in these instruments, as well as attract fresh investor segments, such as FIIs, to the securitisation market. This move has the potential to help provide stimulus to the much-needed secondary market liquidity of PTCs; however various near-term challenges abound. Additional costs involved with listing may be a dampener for Issuers; also they may take time to gear up their internal systems to meet the stringent reporting / disclosure requirements of the regulator and exchange houses.

Outlook

Securitisation activity in India continues to remain subdued with very few Originators participating in securitisation. The investor set has also remained concentrated with some banks and NBFCs, with very low participation from Mutual Funds during FY2011. Despite the growth in Housing Finance and stated intention by the National Housing Bank (NHB) to revive the RMBS market in India, the issuance of RMBS papers has continued to remain very low. One reason for this is the long tenure coupled with poor secondary market liquidity of securitised paper. In this regard, the SEBI Guidelines on listing of PTCS and model listing agreement are expected to be positive steps that are expected to provide greater transparency and liquidity to the secondary market for these instruments. Nevertheless, immediate impact on issuance volumes is unlikely to be very significant.

Convergence with International Financial Reporting Standards (IFRS) is expected to impact ABS and MBS, as asset de-recognition is a challenge for transactions wherein the Originator provides credit enhancement. Nevertheless, the deferment of IFRS implementation to April 2013 for most banks and large NBFCs (April 2014 for small to medium sized NBFCs and urban co-operative banks) could provide some relief for the time being.

The future of microfinance activity in India would be largely dependent on the final recommendations for the sector from RBI. Though some of the recommendations proposed by the Malegam Committee, if accepted pose operational challenges for the sector, they may have a positive impact in the long run. Moreover, the continuity of PSL status for Microfinance loans will have a positive bearing on securitisation of microfinance loans. On the other hand, the removal of agri-status for loans against gold jewellery is expected to bring a slack in the securitisation of these loans. Receivable streams that could potentially be securitised in the medium term include toll road receivables, annuity receivables, and property lease receivables.

Pace of growth in loan book size among key players would be a basic determinant of level of securitisation activity. The final shape of the proposed regulatory guidelines regarding the MHP and MRR as well as their applicability to bilateral assignments will be key developments to watch out for in FY2012. In the short run, funding needs together with regulatory prescription—such as priority sector lending guidelines—are likely to remain the key factors prompting lenders to securitise. Higher activity may be expected in the second half of the current year (FY2012), as has been the case in the past, with banks keen to meet their annual PSL requirements. Overall, going forward, ICRA expects the issuance volumes to remain modest, in the backdrop of uncertainty regarding the final regulatory prescriptions and subdued investor demand.

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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