

India Special Report

Indian Securitisation Market Q&A

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Related Research

Fitch Special Report: “*Securitisation in India: 2005 Review*”, 27 February 2006, available on www.fitchindia.com.

■ Overview

This commentary is drafted as a Q&A to address the most frequently asked questions on securitisation in India. It aims to provide national and international participants with an insight into how Fitch Ratings views the market.

The first securitisation transaction in India was completed in 1991. The market has subsequently matured tremendously, with particular growth in the past three years, and there is now an established investor community and regular issuers. Structured finance has become a solid source of funding via the capital markets in India. Although the market remains predominantly domestic, with ratings assigned within the national scale, efforts to access the international capital markets are being explored by larger originators.

Issuance volume by number of transactions is significant in India, with dozens of deals coming to market each year across all asset classes. Yet significant growth potential within this market remains, with public sector banks still not having entered the securitisation arena. Indian issuers have also still to explore foreign debt capital markets and a wide range of structures and asset classes.

Below are a selection of securitisation-related questions and Fitch’s response, highlighting current trends, key players and perspectives within the Indian market.

What are the Main Characteristics of the Indian Securitisation Market?

India is a significant securitisation market in Asia by number of transactions arranged each year, yet securitisation it is still largely confined to domestic issuances. The market displays a set of unique features that distinguish it from other jurisdictions. Some of the most prominent characteristics are outlined below:

- a. Senior notes are generally enhanced through a cash reserve or guarantee provided by a highly rated institution, usually rated ‘AAA(ind)’/‘AA(ind)’.
- b. National ratings in India denote timely payment of interest as well as principal. This is probably the main difference to most other jurisdictions, where generally only timely payment of interest applies.
- c. The investor base is limited, comprising mutual funds, insurance companies and a few private sector banks.
- d. Most investments in securitised paper are made on a “hold to maturity” basis.
- e. Pass-through certificates (“PTCs”) are still not classified as securities and hence are not tradable on the stock exchange. The secondary market for securitised paper is therefore virtually non-existent with little trading and all issuance being privately placed. Most common asset classes include:

- asset-backed securities (“ABS”) such as auto loans, two-wheeler loans, commercial vehicle loans, construction equipment loans and personal loans;
 - residential mortgage-backed securities (“RMBS”); and
 - credit products (single loan sell-downs and collateralised debt obligations (“CDOs”)/collateralised loan obligations (“CLOs”)).
- f. No transaction has defaulted to date.

What are the Main Incentives to Securitise in India?

Originators

For originators, the main incentives to securitise are threefold:

- until February 2006, upfront booking of profits;
- regulatory capital relief; and
- liquidity/alternate sources of funding.

Investors

Investors in PTCs are mostly insurance companies, mutual funds and private banks. Although several prepayment-protected transaction structures have emerged in the market recently, offering a fixed income and fixed maturity notes and making it easier for mutual funds to invest into PTCs, the investor community remains limited.

The main incentives for investors in Indian securitisation are the same as for their global counterparts: diversification of investment portfolios and to secure highest possible yield at low risk

A key driver for banks to invest in RMBS paper is to fuel the “priority sector lending” norms established by the Reserve Bank of India (“RBI”). The RBI has defined lending contingents that banks need to fulfil in three priority sectors, namely housing, infrastructure and agricultural. In particular, private banks that may fall short of the lending volumes required and hence invest in RMBS paper as a substitute for extending housing loans.

Which Asset Classes are Being Securitised the Most?

Over time, the market has extended into several asset classes. While auto loans and residential housing loans are still the mainstay, corporate loans, future flows, project receivables and toll revenues have all gained in prominence over the past two years. CMBS and CDOs have also generated market interest but transactions in either of these asset classes have yet to establish themselves.

Early attempts to bring national and international synthetic or cash flow CDOs to the market have not yet succeeded. However, a large number of single loan private transfers (referred to as single loan sell-downs) have been executed in recent months. This works by a lender of a corporate loan privately selling its loan engagement to an investor for a discounted upfront principal payment.

During 2004-05, several CLO transactions surfaced, essentially to obtain capital relief. However, these have not been repeated on a regular basis since.

Asset-backed commercial paper (“ABCP”) conduits have yet to surface in India and until the RBI publishes official guidelines on revolving structures, this type of transaction is not likely to take off.

With renewed interest in project finance, securitisations of toll receivables, telecoms towers and other future flow receivables from infrastructure projects are being enthusiastically discussed. Another important growth area is the securitisation of lease receivables: prominent lease finance companies and the Indian Railway Finance Corporation (a central government organisation) have recently securitised their lease receivables.

How are Transactions Credit Enhanced?

Due to the lack of investors for lower rated notes, credit enhancement provided by way of principal subordination is not common among Indian securitisation structures. Notes are all ‘AAA’ tranches where credit enhancement is provided either through a cash collateral/reserve fund or through guarantees/undertakings from the originators themselves.

Where full or partial principal subordination has been used, the subordinate tranche is retained by the originator as a means of reducing the amount of cash that needs to be provided as collateral.

The market has recently witnessed a few transactions where a second-loss piece has been funded by a third party. However, this trend has yet to establish itself as common practice. The main incentive for funding the second-loss piece is to avoid the excess capital charge that would have been levied had the tranche been retained by the originator.

In most transactions, excess interest spread (“EIS”) is structured to act as credit enhancement by being available to top up the cash collateral, if used in the previous period, as well as to cover interest and principal shortfalls in any given period. In other markets, EIS can be used to build up the reserve fund. In Indian transactions, however, if it is not used for either of the abovementioned reasons, the full EIS will flow back to the originator.

What Legal Issues are Involved?

The Special-Purpose Vehicle

The most common form of special-purpose vehicle ("SPV") used in securitisations is the trust. A trust is formed (or declared on a specific set of assets) with a third party appointed as trustee. The formation and working of the trust is governed by a trust deed and generally has a clause allowing resignation/replacement of the trustee. The trust then buys the assets from the originator and holds the assets on behalf of the investors. Each investor has a beneficial interest in the trust assets, including all the receivables that are generated from the assets.

Assignment of Receivables

Under a normal securitisation, a pool of assets is assigned to the SPV by way of an assignment agreement. The SPV, subsequent to such an agreement, becomes the sole owner of the receivables and holds the interest in the assets on behalf of the noteholders. This separates the assets completely from the originator (seller). The deed of assignment constitutes a document indicating assignment of assets. This means that stamp duty is levied by the state in which the transaction is being undertaken. In many states, the stamp duty applied to the conveyance of immovable property continues to be prohibitively high, ranging from 3% to 15% of the value of the property being conveyed. This makes any securitisation unfeasible, particularly for RMBS deals, so originators generally avoid assets from states with high stamp duty. Many states have amended their stamp laws to impose rates as low as 0.1% with a certain upper limit on securitisations. This has provided a boost to issuances.

Tangible Underlying Securities

Transfer of tangible securities backing any loans is a huge challenge in view of the high costs involved, particularly in the case of mortgage securities. Stamp duty, a transaction tax payable on the transfer of the tangible security, is still very high in most states in India. Added to this is the cost and lengthy procedure involved in registering such transfers in the case of immovable property as required under the Registration Act. In view of this, originators, in the case of RMBS transactions, hold the mortgage securities in trust on behalf of the SPV. Hence, although the possession of the security remains with the originator, the SPV, on behalf of the PTC-holders, is the beneficiary of the security/mortgage interest. All documents involved in a securitisation normally have clauses that require the originator to enforce the security if so required by the SPV.

Servicing

Third-party servicing is not common practice in Indian securitisation structures. Generally, the originator retains the function of primary and special servicing. This is because Indian banks are currently grappling with the design and modernisation of their information systems and the infrastructure for third parties to access information regularly for a securitised pool is not yet available. As a result, the rating of the PTCs continues to rely on the originator and its ability to service the securitised portfolios. Business factors, such as retaining the client relationship, also favour keeping servicing in-house as borrowers do not appreciate frequent changes in the collection agent. The originator (seller) therefore continues to act as servicer for the underlying loans under a servicer agreement entered into with the SPV. Generally a replacement clause is built into the agreement, where the SPV has the powers to replace the servicer with a third party in the event of bankruptcy of the originator. However, this eventuality has not yet arisen in the Indian market as most originators are highly rated banks or non-banking financial companies ("NBFCs").

Documents

The documents entered into during a securitisation vary slightly depending on the originator and SPV. Standard documents used are:

- deed of assignment;
- trust deed;
- cash collateral and liquidity reserve agreement;
- securitisation and servicing agreement;
- information memorandum; and
 - a. legal opinion consisting of the following opinions:
 - b. that the transaction is a true sale;
 - c. that receivables would be bankruptcy remote;
 - d. conformity to Indian laws;
 - e. conformity to tax laws; and
 - f. confirmation that documents are stamped in accordance with the stamp duty laws of the respective jurisdiction.

What are the New Guidelines on Securitisation Issued by the Reserve Bank of India?

On 1 February 2006, the RBI published revised guidelines on the regulatory treatment of the securitisation of standard assets. This entirely reshaped the regulatory and market environment for securitisation in India. Issuance levels dropped sharply following the implementation of the guidelines and although volumes have picked up again somewhat, the market has yet to assimilate them and recover.

Following the introduction of the guidelines, transactions have become less attractive from a funding perspective, with, for example, collateral resets of the cash reserves having been suspended. The guidelines have also purged regulatory arbitrage by introducing a rigid treatment of capital maintenance requirements following securitisation. Further key disincentives include the fact that originators can no longer book profits upfront but have to amortise them over the life of the deal.

Key points to these guidelines include the following:

- a. The guidelines apply to banks, financial institutions (“FIs”) and NBFCs.
- b. Any profit derived from securitising a pool of assets has to be amortised over the life of the notes issued under the securitisation and can no longer be booked upfront.
- c. Credit enhancement provided by way of cash collateral is subject to a one-to-one capital charge.

For the first-loss piece, the smaller of the capital that would have been required had the assets been retained on the books and the actual tranche size, applies.

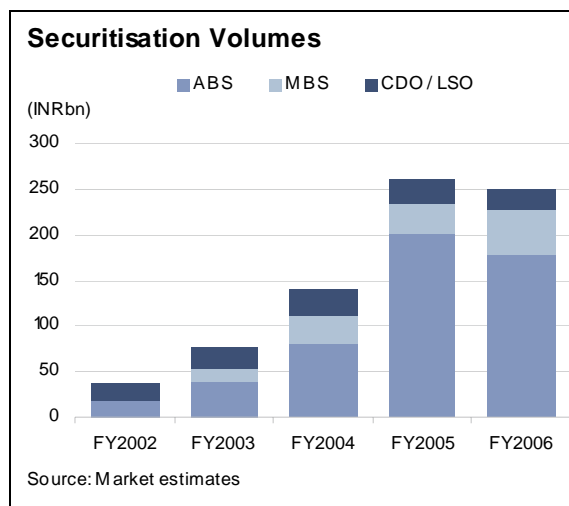
For the second-loss piece, a one-to-one capital charge on the full tranche size applies if the tranche is held by the originator. If funded by a third party, however, it would be risk-weighted as normally required for holding such assets. Please refer to the diagram in *Appendix 1* for a graphical overview of the regulatory accounting impact of the RBI guidelines.

- d. No collateral resets are allowed, i.e. the credit enhancement provided at the start of the transaction cannot be reset over the life.
- e. The originator may invest in notes issued from its own pool of asset of up to 10% of the most senior tranche. Any investment in excess of 10% is subject to a one-to-one capital charge.
- f. A clean-up call can only be made once the pool has been paid down to 10% of the initial balance, providing that such assets are performing. This has the effect of suspending investor put options structured into earlier transactions.
- g. Initially, transactions were sold without a rating; however, following the guidelines, all transactions require at least the assignment of one credit rating.

How has the Market Performed to Date?

Fitch estimates that issuance volumes in the Indian structured finance market almost doubled between FY02 and FY05. In FY02, total volumes were around INR37 billion, rising to around INR260bn in FY05. Volumes grew at a compound annual growth rate of more than 75% over this time.

Fitch estimates issuance volumes in FY06 to reach an amount of around INR249bn (see chart below), declining marginally on FY05. ABS issuance in 2006 has been around INR178bn in to date. This continues to claim the biggest share of the total structured finance market. The overall drop in volumes expected in 2006 can be attributed to the draft guidelines on securitisation that came into effect in February. The tight liquidity conditions and high interest rates this year have also contributed to the slowdown in securitisation volumes.



Activity picked up again in September but at a slower pace. Fewer transactions than in September 2005 were concluded. However, volumes of direct assignments have been steadily growing since the issuance of the guidelines.

It is worth noting that since the securitisation market began in India in 1991, not a single deal has defaulted and investors have, to date, received back their full principal investment along with the forecast yield. Several transactions, particularly RMBS, have been called ahead of schedule due to high prepayments in the underlying portfolios. This has been driven by the volatile interest rate environment in India.

What are Direct Assignments?

Termed “whole loan sales” in other markets and direct assignments in India, these types of bilateral transactions are becoming increasingly common. They do not entail the legal requirements found in securitisations

and are less complex and are therefore more attractive to sellers.

For example, in general securitisation structures, stamp duty is levied when the assets are sold to an SPV. With direct assignments, however, the transfer of the tangible security is only effected upon the breach of certain predefined performance triggers, thus avoiding this cost. Hence, the assets remain on the books of the seller and are held on trust for the buyer. Credit enhancement is provided by the originator to sustain a desired rating level.

However, a major drawback in such transactions is the lack of exposure to capital market investors. Buyers of such loans are either banks or NBFCs. The process does not involve an SPV or issuance of notes and these transactions are, therefore, not entirely bankruptcy remote: they simply shift the bankruptcy risk from one entity to another. Such transactions are commonly undertaken by foreign banks or new banks that aim to build up their asset portfolios or meet the sectoral lending contingents prescribed by the RBI.

Can Foreign Parties Invest in Securitised Paper Issued in India?

There is no clear-cut answer to this question as things stand. It is certain, however, that investments can only be made by foreign institutional investors ("FIIs") registered with the Securities and Exchange Board of India ("SEBI") and under the guidelines dictated by the RBI.

FIIs are currently permitted to invest in debt securities issued by companies that are listed, or to be listed on the stock exchange. However, since PTCs issued under a securitisation are not yet classified as securities under the Securities Contract Regulation Act, 1956, it follows that FIIs cannot presently invest in such paper.

There are plans to amend the Securities Contract Regulation Act to include PTCs under a securitisation within the definition of "securities" under the Act. The Securities Contracts (Regulation) Amendment Bill, 2005 was introduced in the Lok Sabha (the lower house of the Indian parliament) on 16 December 2005 pursuant to the announcement in the 2005-06 budget on the provision of a legal framework for trading securitised debt, including

mortgage-backed debt. The bill has been referred to the Standing Committee on Finance.

Once enacted, this bill will allow for the listing of securitised debt on the stock exchange and will, therefore, make the market more liquid. This will also create a secondary market for securitised paper, making securitised debt more fungible and accessible to third parties. Fitch believes that once debt securities become listed, this will encourage the entry of new investors into the market, including foreign investors.

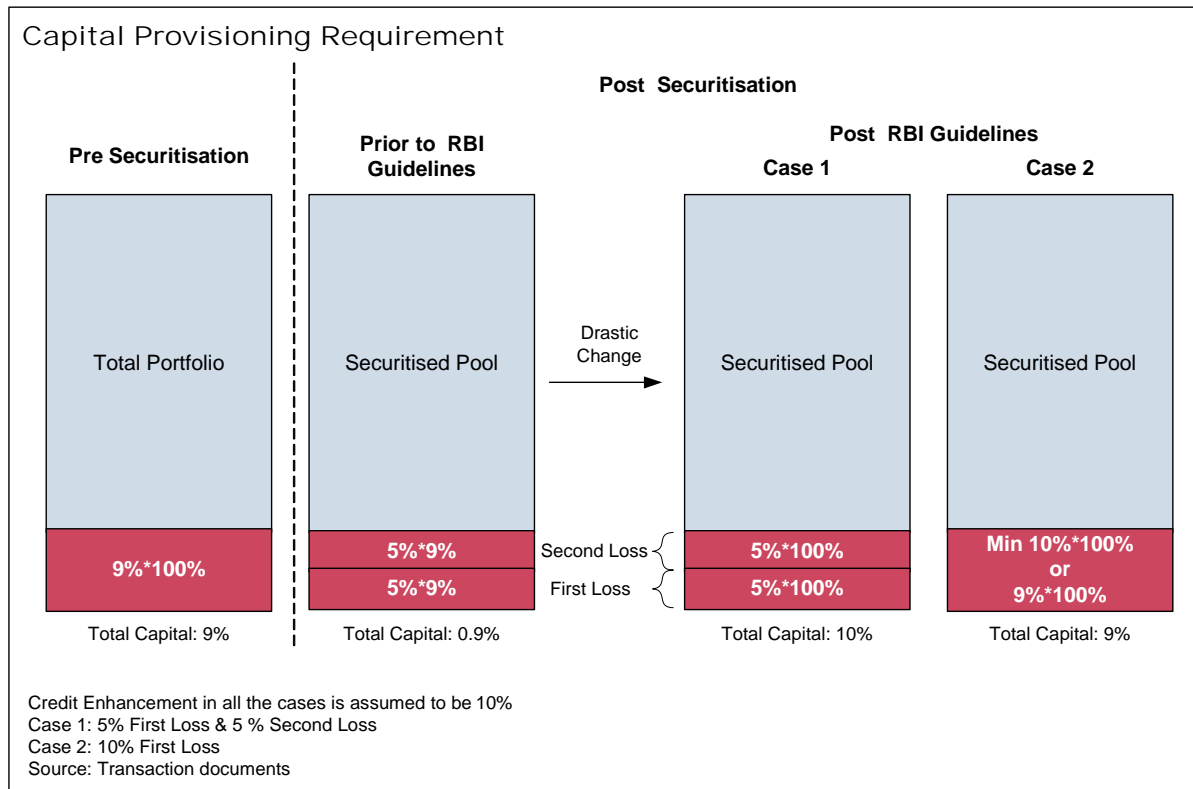
Can Cross-border Transactions be Expected in Future?

Although investors are interested in international transactions, to date no cross-border structures with underlying Indian assets have been implemented. The main reason for this is fact that India remains a highly regulated market with the RBI maintaining stringent regulation on the inflow and outflow of foreign currency debt.

Further, the legal implications for the perfection of security interest with an SPV domiciled outside India may prove cumbersome and costly. From a credit point of view, the prevailing currency and country ratings also pose an obstacle and constraint for cross-border transactions. With the Indian rupee not being a convertible currency, the structuring of a cross-border deal may prove uneconomical as the currency rating ceiling of 'BBB-' could only be breached through the provision of additional credit enhancement or an insurance in addition to a long-term swap to hedge the FX risk. It is also to be noted that India has an established investor community and a large domestic debt market. Indian investors are familiar with the prevailing environment and hence do not have the same yield expectations as international investors when looking at Indian debt.

Although originators in India have tried to address the above issues by attempting to complete offshore CDO structures, whereby only the underlying credits were Indian but the actual loans were denominated in a foreign convertible currency, none of these attempts have actually materialised thus far. Fitch believes that only after the RBI relaxes current regulations will there be true potential for international transactions and cross-border structures to establish themselves in the Indian securitisation market.

■ Appendix 1



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