A Commentary on RBI's Draft Framework for Securitisation of Standard Assets, 2020

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The Reserve Bank of India (RBI) placed for public comments, its [draft framework for Securitisation of Standard Assets] in June 2020 (henceforth RBI's draft securitisation framework). This framework has several positive elements to it such as the removal of direct assignments from the definition of securitisation, the clarifications on single loan securitisation and on replenishing transaction structures, as well as the introduction of the Simple-Transparent-Comparable (STC) framework of the Basel committee on Banking Supervision (BCBS). In this note, we provide a commentary on the overall framework as well as on certain specific aspects. In providing this commentary, we do not strictly restrict ourselves to only this draft framework but also comment on its impact on the overall development of the securitisation market.

1. RBI can articulate a clear vision, the rationale, and a roadmap for how it sees its draft securitisation framework enable the development of the Indian securitisation markets and its various participants

The RBI's draft securitisation framework presents an admirable leap forward for the financial system as it significantly improves upon the existing guidelines. However, a clear vision of the RBI in terms of the market failure that is being addressed through these regulations, the rationale for each of the elements in the framework, and a roadmap for implementing RBI's vision, is unavailable to market participants. It would be helpful for RBI to clarify its intent for the following design elements:

a) The framework currently does not demarcate between RBI's stance on how originators (banks, NBFCs) who supply assets into Special Purpose Vehicles (SPV) are to be regulated versus how investors in securitised paper are to be regulated. The investor universe for securitised paper comprises banks, NBFCs, pension funds, insurance companies, Mutual Funds and Alternative Investment Funds, Foreign Portfolio Investors (FPIs), High Network Individuals (HNI), family offices, and multilateral development banks, among others. RBI's objectives in the context of this investor universe is limited to how it wants its regulated entities (namely banks and NBFCs) to partake in investing in securitised paper. A framework can benefit from a clear separation between regulations for originators and that for investors within the universe of RBI-regulated entities.

b) Currently, the domestic investor base comprises predominantly of a few private sector bank, NBFCs, insurance companies, MFs, HNIs, among others. If the regulatory objective is to widen the investor base for securitised paper, then RBI's mandate is limited to investors who are its regulated entities. Therefore, to meet this regulatory objective, a combined framework put out both by RBI and SEBI that lays out separate regulations for all securitised paper and just listed paper is in order.

c) The policy objectives that get served through enabling STC transactions is left unsaid. In introducing STC securitisations, RBI can lay out a vision for whether it seeks to obtain a shift away from the current market characteristics that consist largely of bespoke securitisation transactions, to one where it wants to see considerable STC securitisations picking up.

d) Since listing does not guarantee liquidity, RBI can provide clarity on the purpose that is expected to be served through mandatory listing. While listing serves many purposes, and is not presently disallowed, there are several reasons why listed securitisation transactions are only very few and secondary trading almost non-existent. If the objective is to attract more offshore investors to invest in securitised paper in order to broaden the base of investors, this needs a different approach as opposed to if the objective is to enable secondary transactions of listed Pass-Through Certificates (PTC) by domestic investors (which today comprise predominantly of RBI-regulated banks and NBFCs).

e) RBI can provide clarity on why it is considering a separate treatment for Residential Mortgage Backed Securities (RMBS) (such as reduction in Minimum Retention Rate or MRR, and mandatory listing) as compared to all other securitised paper.

2. The case for capital neutrality versus capital relief

The RBI must consider whether the overall capital needed in a securitisation transaction is equal to or greater than the capital needed to directly hold the underlying assets without any risk transfer (this depends greatly on the riskiness of the underlying assets being securitised today). Clarity on this is needed to answer the question of what RBI sees as the purpose of securitisation in the Indian banking system (and the domestic financial system) that is severely capital constrained and is inadequate in size to serve the credit needs of the real economy.

If securitisation is to serve the efficient movement of risks *within* the banking system (including from and to NBFCs), then atleast capital neutrality must be ensured (so that transactions do not happen to capitalise on capital arbitrage opportunities). Two scenarios that market participants would now consider are:

A. <u>Capital charge that was applied in past transactions versus that to be applied in new non-STC transactions:</u> Here, the RBI's draft securitisation framework suggests that while banks have the option of choosing between SEC-ERBA (Securitisation: External Ratings Based Approach) and SEC-SA (Securitisation: Standardised Approach) approaches, NBFCs cannot use SEC-SA (which currently prescribes a 100% risk weight). While there might not be any intention to have regulatory arbitrage between ERBA and SA, this might have different implications in terms of capital charge particularly for the NBFCs among the junior tranche holders. The RBI can therefore consider the following:

   a) RBI must allow both banks and NBFCs the freedoms to choose between SEC-ERBA and SEC-SA.

   b) RBI must monitor closely the differential capital treatment for a sample of securitisation transactions across the two approaches (SEC-ERBA and SEC-SA) for whether there are distinct regulatory arbitrage opportunities between the two. Previous studies/reports have found that the approaches laid out by

BCBS are not capital neutral and that there are ways to minimise risk weights irrespective of the underlying risk in the structure[2].

B. Capital charge between non-STC and STC-transactions in new framework: Here, there is considerable capital relief in opting for STC-compliant securitised paper, implying that the RBI wishes to use this as a way to 'incentivise' more simple-transparent-comparable activity without disincentivising 'bespoke' transactions that are the norm today. The capital relief from STC transactions certainly make it more attractive for traditional public sector banks who otherwise do not have interest in or the equity for investing in PTCs (See section 8 for more details). This could potentially expand the universe of domestic investors who are banks.

However, if the securitisation market is to serve the purpose of *expanding* the investor universe beyond banks and NBFCs, to wholesale investors, FPIs and HNIs who are not constrained by domestic economic capital constraints, then there are significant informational asymmetries to be overcome through infrastructural and policy tools described in Section 3.

3. Mandatory Listing as a policy tool is necessary but not sufficient: Downstream issues need resolving

A secondary market purchase of securitised paper can happen either as an Over-The-Counter (OTC) trade or as a transaction on an exchange. Currently no secondary market transactions are happening, whether it be OTC or on an exchange. For a potential investor to consider a purchase, she/it needs access to detailed information on the performance of the paper. Therefore, while listing is a necessary step, it is not sufficient, and the following issues need to be addressed.

A. Disclosures must work for investors interested in participating in the secondary market
Disclosures for listed securitisation transactions are currently required to be posted at the time of issuance to the National Securities Depository Limited (NSDL), which is the depository. NSDL gives details of all transactions that have taken place, the maturity date, pricing and so on for each ISIN (each tranche gets an ISIN) and such information is accessible to all. However, disclosures which are continuing in nature (and made to those already invested in the PTCs) are not accessible to all or are not posted to the depository. Currently there is no reporting on the amortisation of the PTCs to the depository. So potential investors have no way of determining the performance of a listed paper on an updated and reliable basis[3]. Therefore, a balance needs to be reached

[2] Securitisation: The Road Ahead. Miguel Segoviano, Bradley Jones, Peter Lindner, and Johannes Blankenheim. IMF Staff Discussion Note, January 2015. Accessed from https://www.imf.org/external/pubs/ft/sdn/2015/sdn1501.pdf ; Quantitative Impacts of BCBS 269 Securitisation Capital Approaches. William Perraudin. Risk Control Limited 2014. Accessed from https://www.riskcontrollimited.com/wp-content/uploads/2015/02/Quantitative_Impacts_of_BCBS_269_Securitisation_Capital_Approaches.pdf

[3] This is governed by RBI's regulations issued from time to time, and Schedule V: Disclosures to be made in the offer document, SEBI (Issue and Listing of Securitised Debt Instruments and Security Receipts) Regulations, 2008 (Last amended on April 17, 2020). Accessed from https://www.sebi.gov.in/legal/regulations/may-2008/securities-and-exchange-board-of-india-issue-and-listing-of-securitised-debt-instruments-and-security-receipts-regulations-2008-last-amended-on-april-17-2020-_34627.html.

between obtaining loan-level disclosures and transaction level disclosures[4], that works for the unique features of the Indian context. RBI and SEBI can also consider how reliable information can now be made available to 'potential investors' either freely (which implies this information is available to the public at large) or 'on request'[5] at reasonable cost to the relevant exchanges/depositories.

For unlisted transactions, granular information is available only to investors already invested in the securitised paper and the assumption here is that investors are comfortable and intend to hold-to-maturity, such paper.

The RBI can categorically distinguish between disclosures for listed transactions and that for all transactions so that even for unlisted transactions, certain levels of information are available to market participants and to the RBI. To this end, Annex 2 of RBI's draft securitisation framework can be split into disclosures to be made in offer document, and disclosures to be made post primary issuance, and to also clarify for 'all transactions' and for 'listed transactions' separately. Over time these disclosures will become historical data that will aid decision-making by potential investors. Access to data on past transactions that an investor did not partake in, will now become accessible for the investor to invest in a future transaction.

B. Streamlining listing and reporting processes

A comprehensive review of the disclosure framework and an attempt to streamline the entire information flow architecture and the infrastructure for the same needs to be undertaken through a multi-stakeholder exercise by regulators (RBI and SEBI) and depositories. This would then ensure that data flows from the originator to the trustee, then to the depository and then to the exchange, can reach potential investors in a smooth manner. There is a role for both RBI and SEBI in this regard.

Additionally, a variety of market practices exist today to ensure that loans already securitised are not added into new securitisation transactions. Credit rating agencies (CRA) or auditors carry out sample audits of loans in this regard. With the development and expansion of the market for securitised paper, such deduping efforts will need to become much more comprehensive and streamlined. One possible solution could be to include a flag on whether a loan has been securitised or not in the envisioned Public Credit Registry (PCR). The PCR can store loan-level information about whether the loan has been securitised or not (in the form of a master repository of records on securitised assets).

[4] For instance, ESMA obtained responses from market participants and concluded that it would remove PD and LGD fields from the underlying disclosure templates for reporting and instead require PD and LGD figures to be disclosed at the level of the securitisation transaction. See Pg.22, Final Report: Technical Standards on disclosure requirements under the Securitisation Regulation, 22 August 2018. Accessed from: https://www.esma.europa.eu/sites/default/files/library/esma33-128-474_final_report_securitisation_disclosure_technical_standards.pdf

[5] Taking a leaf out of the approach of ESMA. See Annex I: Legislative mandate to develop technical standards; Final Report: Technical Standards on disclosure requirements under the Securitisation Regulation, 22 August 2018. Accessed from: https://www.esma.europa.eu/sites/default/files/library/esma33-128-474_final_report_securitisation_disclosure_technical_standards.pdf

C. All transactions beyond specified thresholds must be brought under the listing requirement

Mandatory listing will increase transaction costs in the short term but may perhaps be needed for informational transparency outcomes that are key for long term market development. If RBI decides to use mandatory listing as a policy tool, then all types of transactions and not just RMBS transactions must be brought under the mandatory listing requirement and thresholds to be arrived at for ABS based on what is appropriate for the market. Transferability and tradability issues are easier to surmount for shorter tenor paper to make it worthwhile for both domestic and overseas investors and hence ABS markets must be brought under mandatory listing.

D. Infrastructural issues need to be addressed for RMBS

It would also be worthwhile for RBI to provide clarity on how it seeks to address other issues plaguing the RMBS markets in India if its objective is to create liquidity in the market for RMBS paper. Many investors, particularly overseas investors and insurance companies do not invest in RMBS paper on account of lack of liquid hedging markets for interest rate risk. This needs to be addressed. Also, RBI's Housing Finance Securitisation Committee made a number of recommendations on security interest creation and transferability with respect to RMBS. RBI would need to address some of them where it can, or formally make representations to the respective authorities within the Central Government and collaborate to lay out a roadmap for resolving them before mandating listing of RMBS transactions.

In the event these hurdles do not get sorted for the financial system, listing would only be an additional cost to be incurred to execute securitisations. We might end up seeing distortionary behaviour by market participants who would want to avoid this cost and in doing so, execute transactions that fall just short of the Rs. 500 crore mark. Such distortions have negative consequences for these markets to develop well.

4. The case of the junior tranches in securitisation transactions

Key to building securitisation as an important risk transfer mechanism is that there be adequate investors with capital that can come in as junior tranche holders. The quality of the junior tranche would be key to dictate the quality and ratings of senior tranches that the more conservative investors as well as overseas investors can hold. While in the past, banks, NBFCs, DFIs, as well as unregulated institutional investors and HNIs have stepped in as critical second loss providers, the risk weighting implied by the RBI's draft securitisation framework could indicate a much higher capital charge for NBFCs, which could result in a loss of interest in junior tranches by this investor base. The market may see a shrinking of this investor base for the purpose, which will, in turn, reduce the volumes in assets securitised.

While a temporary readjustment of the market is not always a bad outcome, RBI must consider analysing historical data on performance of junior paper in order to a) create adequate database based on which it can fine-tune capital charge regulations to ensure its objectives are being met, and b) to assess whether the performance of the credit risks (and more importantly, losses

incurred) in junior tranches can justify the capital charges applicable on them. If capital charges are too harsh for the losses incurred on junior tranches, RBI can revisit the capital charge regulations as required.

Given that NBFCs have a minimum CRAR requirement of 15% and banks have 9%, RBI can clarify that investing in junior tranches will attract risk weight requirements of 1111% and 667% for banks and NBFCs, respectively.

5. Transactions permissible under the definition of securitisation

This brings us to the language used to define 'traditional securitisation'[6], which is the only permissible kind of securitisation in India under the RBI's draft securitisation framework. Conversations with practitioners suggest that there are securitisation transactions with a single tranche and in which the originator provides equity cushions through overcollateralization, which is a securitisation transaction, but which would now not qualify. Particularly in the event where there is not enough participation available in junior tranches (see section 2) due to stringent capital requirements, disallowing the option of single tranche securitisation may be counterproductive to the objective of building securitisation as a reliable option for moving credit risks out of one's balance sheets through repackaging.

6. First Loss versus MRR as a policy tool: whether to regulate the proportion and/or form of MRR

Instead of making a decision between two competing options, RBI can specify the general principle that needs to be upheld in meeting MRR, which is that no portion of MRR must receive treatment as being senior to any of the tranches in the transaction.

RBI can reinstate the word 'substantial[7] to describe the nature of first loss which serves to ensure skin in the game for the originator. Additionally, RBI can consider clarifying that second loss, if provided by the originator, should be knocked off completely from the capital[8]. In the absence of these two clarifications, it may become possible for an originator to provide only 1% first loss and the remaining as second loss to meet the 10% MRR.

7. The justification for cutting down MRR for RMBS

It is unclear why RBI chose to reduce MRR for RMBS and therefore RBI can provide a justification for the same. This is particularly important because the issues around transfer of mortgage in property is a confounding factor for RMBS to take off in India and increases the risks for investors. RBI can also clarify whether loans that can be packaged into RMBS consist only of loans taken for purchase of new homes or whether it can also include loans against property (LAP), loans against existing homes, and the like.

[6] 'Traditional securitisation' is defined in the RBI's draft securitisation framework as a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk, where payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the originator.

[7] 11.12 and 11.13, Guidelines on Securitisation of Standard Assets, RBI, 2006, require first loss facility to be 'substantial'. Accessed from: https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=2723&Mode=0

[8] 12.2, ibid

8. Perceived differences in treatment of PTCs versus directly originated/purchased loan needs addressing

It is to be acknowledged that banks' participation in securitised paper is driven by Priority Sector Lending mandates placed on them by RBI. A majority of these are Direct Assignment (DA) transactions that got reported under securitisation. While DA transactions are executed by the retail and corporate credit teams in banks, investments in PTCs is undertaken by their treasury departments. It is much easier for the collection team to spring into action to take over collections in a DA transaction if the originator were to stop meeting its servicing obligations. In securitisation transactions, protections are in the form of junior tranches, first loss protections from the originator (DA does not entail first loss from the originator), and continued scrutiny by CRAs.

Despite these protections, a majority of banks prefer the DA route to meeting PSL mandates because of their familiarity with it, and because of business practices that perhaps incentivise direct loan book growth to build AUMs rather than evolve strategies that include contributions from corporate or wholesale banking. Our conversations with practitioners indicate that while many private sector banks with better quality core-banking systems consider PTCs as part of their AUM, public sector banks (PSB) do not. A greater understanding of the protections in place can help PSBs to hold PTCs instead of only considering lending to originators directly. STC-compliant transactions may also help in this regard particularly for paper that banks want to hold to maturity (HTM).

The other hurdle that prevents banks from evolving strategies that consider holding PTCs in the investment book is the restrictions on holding them as HTM based on declared intent. While listing can make it much easier to do mark-to-market for holding PTCs in the investment book, even if held to HTM, there are other restrictions that prevent this. Banks can hold only specified non-SLR securities in the HTM category and only up to 25% of their investments in the HTM category. Taken together, these restrictions act as a significant barrier for banks to expand their investments in PTCs[9]. The RBI can consider permitting listed PTCs to be classified under HTM category if banks intend to hold them to maturity.

9. Sale of PTCs to retail investors

RBI can clarify whether retail investors are permitted to participate in PTCs or whether PTC sales is restricted only to institutional investors. While HNIs and other sophisticated retail investors must continue to have freedoms to invest in securitised paper, there is anecdotal evidence today that PTCs are being pitched to retail unsophisticated investors (who do not consider themselves as HNIs). RBI can clarify the contours within which retail participation can be allowed

[9] A discussion on the same can be found in The Risk Aggregator Model in Banking for India, Madhu Srinivas and Deepti George, No. 8, Notes on the Indian Financial System, Dvara Research, April 2020. Accessed from: https://www.dvara.com/research/wp-content/uploads/2020/04/The-Risk-Aggregator-Model-in-Banking-for-India.pdf

and if so, the kinds of definitions[10], checks and balances[11] that must be adhered to by market participants in bringing retail investors into this market.

RBI's draft securitisation framework has many enabling features required for the growth and orderly development of the Indian securitisation market. However, these regulations alone would not be sufficient and a greater coordination among the financial sector regulators and the Government is needed to ensure that concomitant challenges are resolved to gain the full momentum needed for the market to take off.

[10] RBI can, in coordination with SEBI consider whether to introduce an inclusive definition for who can be considered a 'retail customer' such that it includes everyone except regulated financial institutions, qualified institutional buyers, and central, state or local governments. More details of such a definition can be found in Universal Conduct Obligations for Financial Services Providers Serving Retail Customers, Deepti George, No. 7, Notes on the Indian Financial System, Dvara Research, May 2019. Accessed from: https://www.dvara.com/research/wp-content/uploads/2019/05/Universal-Conduct-Obligations-for-Financial-Services-Providers-Serving-Retail-Customers.pdf

[11] In this regard, providers can be permitted to sell PTCs to retail investors provided it can satisfactorily prove that the customer has been adequately warned, and that the provider has undertaken adequate assessment of the customer's expertise, experience and knowledge in relation to the nature of the product being sold and understanding of risks involved. For more details of such as approach, see pg 15, ibid.