Mortgage Backed Securities in India

Issues for the Committee on the Development of Housing Finance Securitisation Market

Indian Securitisation Foundation

403-406, Shreyas Chambers
175, D N Road, Fort
Mumbai – 400 001
Phone: 022-22614021
Email: info@indiansecuritisation.com; vinod@vinodkothari.com
Website: www.indiansecuritisation.com

About ISF

Indian Securitisation Foundation (ISF) is a representative body of the securitisation industry in India. ISF is formed with the objective of developing, promoting and protecting the securitisation, structured finance markets in India in particular, and market for fixed income securities in general.

Securitisation in India is not just a fixed income investing instrument, but essential for the idea of financial inclusion, in form of priority sector lending. Banks meet their priority sector targets partly through portfolio acquisitions and securitisation, thereby putting securitisation at par with the banking book.

It is a clear policy choice to have a strong market for fixed income securities in India: structured finance securities are an essential part of that market, to provide variety, choice and alignment to investor needs.

In this background, ISF was conceptualised to provide direction, leadership, advocacy and support to the securitisation and structured finance industry.

Some of the functions of the Foundation include:

a. Advocacy
b. Industry forums and networking
c. Development of industry standards
d. Information exchange

Mortgage securitisation in India

- While housing finance is the key driver for securitisation world-over, in India, the contribution of RMBS to securitisation volumes is miniscule.
  - The penetration of RMBS to mortgage lending is even lesser
- The sharp increase in MBS-related securities in FY 19 may not be sustained for several reasons:
  - As for some HFCs/NBFCs, securitisation was the only way in FY 19, the same may ease out soon
  - There was an impact of held-back issuance in FY 18 owing to adverse perceptions about GST which was unlocked in FY 19

Possible reasons for low penetration of RMBS in India
Big players and small players market: while number of HFCs has grown to about 100, the top 4 players still command 85% of the market
Larger HFCs have AAA ratings, easy access to bond markets, and substantial internal accruals
NIMs in mainstream prime business are low: securitisation as the tool to encash excess spread does not seem alluring
Credit enhancement levels set by rating agencies lead to capital erosion vis-à-vis risk weights applicable to on-balance sheet position
Stamp duty is though not a breaker, but an irritant
NHB intervention might have been promotional

RMBS in India

Case for RMBS in India

- India has ambitious targets for housing finance
- Securitisation can reduce cost of mortgage lending?
  - This is conditional upon cost of securitisation being lower than cost of on-balance sheet funding
    - Credit enhancement levels have to be optimal
    - Long-term investors such as insurers/employee benefit funds have to invest in these securities
    - Avoidable costs such as stamp duties have to be minimised/rationalised
    - Documentation and transaction structures have to be standardised with multiple benefits such as investor comfort, liquidity, lower costs
- The model has worked elsewhere in the world; must work in India too

How RMBS can particularly help affordable housing finance companies
The list of 100 HFCs has a large number of companies that focus on affordable housing finance
These companies have higher NIMs; lower capitalisation, and operate on lower on-balance sheet leverage
Securitisation can help these companies release capital, release excess spread, and have higher AUM than permitted by on-balance sheet leverage
The companies may not have volumes: hence, multi-originator models work very well for them
Currently, private-label multi-originator models are in operation: however, the cost can be reduced substantially with NHB intervention

Current issues faced with respect to issuance of RMBS in India

- Missing central agency for facilitating/promoting RMBS transactions
- Lack of clear regulatory guidelines for securitisation by HFCs
- Stamp duty on transfer of mortgages
- Lack of clarity with respect to impact of Ind AS on securitisation transactions
- High levels of credit enhancements insisted as per RBI regulations/rating agency stipulations

Regulatory environment for securitisation in India

Key elements of securitisation eco-system

Clear regulatory framework

- Centralised agency for promotion of RMBS
- Contractual/ true sale framework
- Prudential norms for issuers
- Prudential norms for investors
- Capital requirements and capital relief
- Regulations for facilitating entities

Tax issues

- Direct taxes
- Indirect taxes
- Documentation taxes

Standardisation of practices

- Documentation
- Standard program
- Multi-originator issuances

Clarity on accounting rules

- For HFCs following Indian GAAP
- For HFCs following Ind AS

Centralised agency for promoting/ facilitating RMBS

- India lacks an effective centralised agency for promoting/ facilitating RMBS. NHB launched a scheme for promotion and facilitation of RMBS in India, however it failed to achieve the desired objective.

- However, globally, several countries have been able to set-up effective centralised agencies
  - In USA there are three agencies, namely Fannie Mae, Ginnie Mae & Freddie Mac. Notably, almost 95% of the total transactions are agency transactions
  - In Canada, Canada Mortgage and Housing Corporation (CMHC) acts as the centralised agency.
  - In Hong Kong, Hong Kong Mortgage Corporation Limited acts as the centralised agency. Most of the RMBS transactions in Hong Kong are carried out by HKMC.
  - In Malaysia, Cagamas National Mortgage Corporation of Malaysia carries out the agency function. The entity has been floated by the Apex bank of Malaysia – Bank Negara Malaysia along with other banking institutions in the country.

- Apparent questions about centralised agency in India?
  - Ownership structure of the agency
  - Kind of intervention
    - Purchase and re-securitisation of mortgage loans; or
    - Second loss support/ senior investor
      - Second loss support works great as a confidence measure

Prudential regulations for various issuers in India

Nature of entity	Prudential norms
Banking companies	RBI Guidelines of 2006 and 2012
Non-banking financial companies	- Do -
Housing finance companies	None, however, by implication, RBI Guidelines of 2006 and 2012
Non-financial sector entities	None

Prudential regulations for issuers

Major requirements under various jurisdictions				
	India	**EU**	**USA**	**Japan**
Minimum risk retention	10% for loans with original maturity more than 24 months (5% for original maturity upto 24 months – not relevant for RMBS)	5% of the nominal value of tranches sold (for vertical slice) or 5% of the securitised exposure (for other retention options)	5% of the credit risk of assets collateralising any ABS issuance	5% of nominal value of securitised exposures or equivalent amount of credit risk.
Relaxation with respect to MRR	No	Securitisation exposures guaranteed by government authorities	MBS backed by qualified mortgages*	Only if an investor can judge the underlying assets of a securitisation were not originated inappropriately
Minimum holding period	12 months	NA	NA	NA

* The definition of qualified mortgages contains conditions following which mortgage loans would avoid those factors which caused the 2007 crisis.

Qualified residential mortgage

Means any residential mortgage loan—

- for which the regular periodic payments for the loan may not—
  - result in an increase of the principal balance; or
  - except as provided in subparagraph (E), allow the consumer to defer repayment of principal;
- the terms of the transaction do not result in balloon payment
- for which the income and financial resources relied upon to qualify the obligors on the loan are verified and documented;
- in the case of a fixed rate loan, for which the underwriting process is based on a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments;
- In the case of an adjustable rate loan, for which the underwriting is based on the maximum rate permitted under the loan during the first 5 years, and a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments;
- that complies with any guidelines relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay regular expenses after payment of total monthly debt, taking into account the income levels of the borrower and other factors
- for which the total points and fees payable in connection with the loan do not exceed 3 percent of the total loan amount;
- for which the term of the loan, except for certain cases, does not exceed 30 years; and
- in the case of a reverse mortgage, a reverse mortgage which meets the standards for a qualified mortgage, as set in the rules.

Prudential requirements for investors

- Currently, the framework for Banks allow risk weighting of securitisation exposures based on the ratings assigned to the instruments. The same has been presented below:

Rating	AAA	AA	A	BBB	BB	B, below and unrated
For non-originator banks	20	30	50	100	350	1111
For originator banks	20	30	50	100	1111	1111
For commercial real estate securitisation exposures						
For non-originator banks	100	100	100	150	400	1111
For originator banks	100	100	100	150	1111	1111

- However, for NBFCs/HFCs, this rating-based risk weighted approach is not applicable.

Capital relief – the conflict between existing regulations and IFRS

Issue	As per RBI Guidelines	As per IFRS
De-recognition of financial assets	Satisfaction of "true sale" criteria is the only indication of transfer of risks and rewards in the assets	IFRS 9 provides for de-recognition principles. De-recognition can be achieved only on fulfilment of those conditions. There can be three situations: a. Transfer of all risks and returns – De-recognition allowed b. Retention of all risks and rewards – De-recognition not allowed c. Retention of some risks and rewards – Partial de-recognition allowed
Gain/ loss on sale of assets	To be amortised over the tenure of the transaction	If de-recognition achieved, to be booked upfront

Listing and market making

- Despite the presence of SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008, currently none of the RMBS transactions are listed on stock exchanges
- Listing on stock exchanges invites additional compliances as per SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations, 2008 and SEBI (Listing Obligations and Disclosure) Requirements, 2015
- However, listing of SDIs in accordance with the prescribed regulations, allow tax pass through to the instruments, even if they don’t conform to RBI Guidelines of securitisation
- The marketplace in general will stand benefited if listed MBS/ABS issuance is encouraged:
  - Mutual fund investment –proposed regulations permit only listed instruments
  - Listing may promote liquidity and price discovery
  - LODR Regulations for Securitised Debt Instruments need review

Stamp duty implications

- Except for following states, for assignment of loans along with the transfer of underlying mortgages, there is no ceiling on stamp duty on such transactions:

  - Delhi - Maximum Rs. 1 lakh
  - Maharashtra - Maximum Rs. 1 lakh
  - Rajasthan – Maximum Rs. 5 lakhs
  - Gujarat - Maximum Rs. 1 lakh
  - Andhra Pradesh - Maximum Rs. 1 lakh
  - Bihar - Maximum Rs. 1 lakh
  - Uttar Pradesh - Maximum Rs. 1 lakh
  - West Bengal - Maximum Rs. 1 lakh
  - Karnataka - Maximum Rs. 1 lakh
  - Tamil Nadu - Maximum Rs. 1 lakh
  - Chattisgarh - Maximum Rs. 1 lakh

- In addition to the above, there are concerns over registration of mortgages as well. For pools having underlying properties situated in different parts of the country, difficulties are faced while registration. Non-registration of documents have various legal ramifications.

- Practitioners submit that originators are currently doing securitisation only to fulfil their PSL requirements:
  - With stamp duty, they do not have a real motivation in doing that

Potential exemption from stamp duty

- Several exemptions from stamp duty have been given under Indian Stamp Act
  - Section 8E of the Indian Stamp Act has several proposed exemptions
  - Assignment of receivables for the purpose of securitisation can be brought under the exempting clause
- Total revenue across the country in a full financial year will not be more than Rs 25 crores
  - Far outweighed by the benefits of promoting securitisation

Registration requirements

- Currently, mandatory registration requirements emanate from the Transfer of Property Act defining a mortgage-backed instrument also as an immovable property.
- Registration is simply a matter of public record
    - There is a process of registration under CERSAI already
- State-level registration of an MBS issuance is not required from property titling perspective.
- Practitioners have pointed out that this is more of an irritant than even stamp duty
- This needs to be resolved

Legal and bankruptcy remoteness framework

Safe harbour to true sale

- India is one of the common law countries relying on rich traditions of the common law/contractual framework
- There is no statutory pronouncement on “true sale”
- Challenges to true sale may be faced in not-too-distant future:
  - Financial entities going through stress
  - Financial statements may actually be having assets on the balance sheet
  - In terms of actual movement of cashflows, the servicer’s cashflows on account of SPVs/DA transactions run through the regular banking accounts of the originator
  - DA transactions have striking similarity with debt
  - Resolution professionals/liquidators may be inclined towards other stakeholders, rather than securitization investors
- If there is a challenge to securitization transactions, irrespective of ultimate results, the investors will be extremely jittery

Securitisation law: Legislative framework vs. Contractual framework
Merits of common law reliance • Common law is extremely flexible, leaving for the contractual framework to define all that is not prohibited, or unconscionable Demerits of common law based system • Most of the law is based on precedents; the precedents may date back to several decades, hence, not pertinent to capital market transactions • Most precedent-based law is based on its unique factual matrix – hence, no precedent is a good precedent • No safe harbour, leading to complexity, uncertainty, and hence, lack of reliability

Clarity with respect to Covered Bonds

- Covered bonds have been used in continental Europe for over 200 years with no instance of a default
- Covered bonds provide an option to the issuer – in addition to corporate bonds, off-shore bonds, MBS, etc.
- NHB Working Group recommended introduction of covered bonds, laid a regulatory framework
- COBOSAC also picked up covered bonds as an agenda item
- Perceived risks such as superpriority to covered bonds investors etc. may be addressed by appropriate regulatory safeguards – As has been done in most other countries
- Recently, there has been a transaction styled as India's first covered bond – however, it is not based on mortgage pool
- However, it is time for regulators to take notice and recognise covered bond

Distinctive features of Covered Bonds
Covered bonds are on - balance sheet product, with dual recourse – first recourse to the issuer, and second, bankruptcy - protected recourse to cover pool
Half-way house between corporate bonds and MBS: hence, ratings are notched up, but not necessarily AAA
Covered bonds rely partly on the Cashflows of the cover pool and partly on the treasury of the issuer – hence, do not carry prepayment risk or default risk
Bankruptcy protection to covered bond investors comes either by way of a legislative framework (as in Europe), or contractual framework (as in common law countries)
India can rely on flexible common law framework

Representation

With respect to Guidelines on Securitisation

Regulations	Currently, there are no dedicated guidelines on securitisation by HFCs, however, by implication the RBI guidelines are made applicable on them. A dedicated guideline may be issued for HFCs.
Minimum holding period	Internationally, there is no concept of MHP. If possible, the entire requirements may be taken off. In case it is not possible, the MHP on long term loans may be reduced to 6 months. In case of residential mortgages, the disbursements may take more than a year to complete, in that case the effective MHP goes beyond the stipulated timeline.
Minimum risk retention	Internationally, the MRR requirements are lower in case of qualified mortgage loans. However, there is no such concept in India. The same may be introduced to bring the Indian regulations at par with international standards.
Credit enhancement	The current process of reset of credit enhancement is very stringent, and has no parallel in global landscape. The same may be dispensed with and may be taken care of the transaction structure.
Risk weight	Risk weights on investments in RMBS may be pegged with the ratings in case of NBFCs/HFCs.

With respect to Guidelines on Securitisation contd..

Regulatory filing of securitisation transactions	Though provisions of SARFAESI Act deal with regulatory filings of securitisation transactions, however, the same is not followed properly. An effective mechanism for reporting of securitisation transactions must be put in place.
Due diligence and valuation of underlying assets	Guidance with respect to due diligence of loan pools. Also, valuation reports of the mortgages or broad price range of the underlying properties must form part of the information memorandum of the MBS
Clean up call	Considering the long tenure of the MBS transactions, clean up call of 20% must be allowed instead of 10%
De-recognition	As per securitisation guidelines, true sale of receivables is the only criteria for de-recognition. However, IFRS lays down detailed guidance on de-recognition. Both must be synchronised.
Gain on sale	The manner of booking gain on sale of financial assets under IFRS and securitisation guidelines are different. Both may be synchronised

Other issues

Stamp duty	Currently the laws on stamp duty on assignment of receivables in different in different states. The same must be unified.
Registration of documents	Registration, where the underlying assets are located in different states, is difficult. Non registration of documents attract various legal ramifications. Therefore, an unified approach may be adopted in case of registration of documents.
Covered Bonds	Covered Bonds must be promoted as a means of finance. Necessary changes in the Insolvency Laws, Securitisation Guidelines etc. must be made to promote the product.
Third party credit enhancements	Mortgage guarantees and other third party credit enhancements must be promoted.
Process change	❖ The collections account should be a no lien current account, and the money should get transferred to the buyer of the pool directly from collection account. ❖ The underlying security should move to buyers’ control with access to the servicer. This would ensure easy handover of documents in case servicer is changed.

Other issues contd..

Clarification with respect to legal position of investors’ rights on the receivables after IFRS	After IFRS, securitisation transactions often fail de-recognition test, therefore, remains on the books of the originator, despite the legal sale of receivables. A clarification may be issued with respect to the investors’ legal rights on the receivables.

Investments by foreign portfolio investors

Two important changes are required for encouraging FPIs to invest in securitisation transactions:

- Deduction of tax at source, for which provisions are there in case of bonds, but not in case of pass through certificates
- The limit of exposure of 50% in case of issuance by a single entity has been relaxed in case of "security receipts"
- This is also one example of securitisation
- The limit ought to be relaxed in case of securitisation as well

Investment by insurers and employee benefit funds

- Traditionally, in global markets, the largest investors in RMBS are insurance companies and employee benefit funds
  - The transaction is highly rated, long term, and provides yield differentials
- In India, insurance companies have barely made investment in RMBS
- In case of provident funds/pensions, virtually nil.
- Reasons:
  - Regulations in case of insurers are far too complicated – they provide for pool level diligence as well
    - Thereby discouraging the investor
  - In case of EPFs – regulatory changes are also required
  - Substantial confidence building is required for these investors to get the flavour of the product

Mode of financing by SPVs

- Present structure of the RBI guidelines envisages issuance of "securities" by the RBI
- Currently, in India, the only prevalent mode of security is pass-through certificates.
- Other modes of refinancing, such as bonds, notes, loans or other instruments are not practiced
- With bonds, the confusion has been, whether a trust can issue bonds
- Same in case of loans
- This introduces lack of flexibility and discourages innovation

Warehousing facilities

- One of the common ways of financing the build-up of a pool before its securitisation is warehousing facility.
- This is the most common way globally
- The warehousing financier also needs bankruptcy protection
- The present restrictions by way of MHP do not permit a transfer of assets into a trust before completing of the MHP period, thereby disabling warehousing facilities