SECURITIZATION OF HIGHER EDUCATION IN INDIA

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1 EXECUTIVE SUMMARY

"Our progress as a nation can be no swifter than our progress in education. The human mind is our fundamental resource."

~ John F Kennedy

The 2008 sub-prime mortgage crisis and Eurozone debt crisis were two major events which gave Securitization a bad name. As a result of these events many developing nations became very skeptical with regards to use of securitization. On the contrary, securitization is an extremely efficient way to raise funds and manage risk. Securitization holds great potential for emerging nations like India, Indonesia and Malaysia. Government can use securitization as a unique alternative to privatization. They can retain control over socially important sectors like public healthcare, primary and tertiary education and fund these sectors effectively thereby reducing strain on government budget.

The latest 12th Five year plan of the Government of India (GoI) has suggested urgent need of various means to finance higher education in India. Credit Guarantee Funds (CGF) for Higher Education sector, Interest subsidies for student loans and incorporation of a nodal agency for monitoring student loans for Higher education called National Education Finance Commission (NEFC), have been some of the new growths which the government is in process to implement to fund the sector. The recent case of securitization of student loans in Chile, Peru, U.S. & Malaysia clearly outlines that a similar securitization model can be successfully implemented in India as well. In this article, the above mentioned elements of CGF & NEFC have been integrated to give a securitization model which will not only help the government to achieve its 12th Five year plan objectives but also build the Indian financial market by promoting Credit Guarantee Agencies & Monoline Insurance.

2 IMPORTANCE OF HIGHER EDUCATION (HE)

Education is an empowering force in a highly competitive and dynamic socio-economic global environment. No nation can attain sustained economic and social progress without the backing of an 'informed' human capital;

Information is thus power. It is pertinent for an emerging economy like India, which is endowed with the second highest human resource in world, to derive the demographic dividend of this potent resource.

Primary and secondary educations are not sufficient for human capacity building. It is higher education which lends the knowledge to understand and implement innovative techniques for economic progress. Higher education acts as the sharpener which adds edge and insight to make the human resource globally competitive and efficient.

3 THE STATE OF HIGHER EDUCATIN IN INDIA

The progress of Higher Education in India from 1947 to 2000 has been due to a remarkable rise of the middle and higher income groups. From 2000 onwards many private players found regulatory mechanisms to be inhibiting their growth and they took the path of deemed university status to gain degree granting powers. Huge numbers of universities were granted deemed status. In addition, various state governments found that education was on the concurrent list and hence starting promoting private players to set-up many state universities. All of this led to a spurt in growth of HEIs.

4 URGENCY OF CHANGE IN HIGHER EDUCATION SECTOR

4.1 RECOMMENDATIONS OF INVESTIGATIVE REPORTS & STUDIES

4.1.1 THE REPORT OF PRIME MINISTER'S COUNCIL ON TRADE & INDUSTRY

The Prime Minister's Council on Trade & Industry suggested that the problems caused due to the massive rise in student enrolments for higher education and the continuous budget constraints faced by the government, should be solved by -

- Reduction in Government funding through privatization of higher education.
- Systematic replacement of subsidies with higher tuition fee.
- Development of credit market for education.

4.1.2 C.B. SANYAL & M. MARTIN (2006)

C.B. Sanyal & M. Martin in their paper identified seven key factors which have changed the funding mechanism in higher education sector. All the seven key factors align with the recommendations outlined by Prime Minister's Council & Planning Commission.

4.1.3 Pawan Agarwal (2006)

In his working paper it is clearly stated that ". . .a more transparent, rational and formula based mechanism of funding of public-financed higher education institutions." & need of proactive State participation in financing of HE sector.

4.2 Action Points of Government Policies & Plans

4.2.1 Planning Commission - 12th Five Year Plan

The latest five year plan from year 2012 to 2017 puts specific stress on excellence, equity and expansion of higher education. It plans to achieve these three primary objectives by way of governance, implementation, monitoring and lastly but most importantly, through financing. In financing, Government wants to explore 'alternative sources of funding' like sponsorship, endowments and tie-ups with individuals and corporates.

4.2.2 Ministry of Human Resource Development (MHRD) 2012

Ministry of Human Resource Development (MHRD) has proposed the idea of National Education Finance Corporation (NEFC). The 12th five year plan of GoI incorporates NEFC as a unified body for financial resource allocation, play the role of a guarantor and infuse cheaper credit availability for investing in for promotion of HE in India.

4.2.3 Student Loan Defaults

The Problem: In the early 2000, Government introduced a comprehensive education loan scheme which has led to increase in student loan portfolio but the default rate of these loans has risen tremendously. Many private banks are not willing to provide student loans as a result & the data from Credit Information Bureau of India (CIBIL) supports this huge rise in student loan defaults in India.

The Solution: To solve this problem, the Planning Commission in 2012 has remarked that student loans with government guarantee will be universalized. Government now plans to act as a primary guarantor for families with poor socio-economic background. And in case of families with sufficient income per annum, government will act as a cosignatory of the guarantee. Such a mechanism can provide much needed impetus to the banks in promoting student loans.

All the above recommendations act as the point of departure for the proposed model. It is clear from the above points the sense of urgency for innovative way of financing in HE sector.

5 THE PROPOSED MODEL

The point of departure for the proposed model has been from all the recommendations given above. The model for Student Loan Backed (SLB) securitization in india, includes six participants in general and depending on the legal requirements and structural feasibility, the State can add various other intermediaries like administrators etc. We now explain the six participants involved in the structure. They are as follows –

- Students .i.e. undergraduate and post-graduate students
- Guarantors .i.e. Government and International Finance Corporation
- Capital Market .i.e. institutional investors
- Financial System .i.e. Banks
- NEFC i.e. the issuer and Special Purpose Company (SPC)

Students: The students can apply for the loan via internet or by posting the required documents to NEFC. They would have to provide documents supporting their socio-economic status. Once NEFC has approved their application, they will go to the bank to sign in the legal documents.

NEFC : NEFC will be a State controlled entity and will have all the legal characteristics of a Special Purpose Company (SPC). Once the student has submitted the application to NEFC, NEFC will sort all the application as per socio-economic background and the field of study to be pursued (example : Arts, science, engineering etc.). Following this, NEFC will approve applications of the deserving students as per the fiscal budget allocated by the Government. It will acquire the loans which banks assume to be risky and constructs a portfolio of these risky loans along with portfolio of loans approved by the banks, in order to securitize them. In the beginning, NEFC will have its subsidiaries set-up in North, Central, Western, Eastern & North-Eastern parts of India.

Financial System: The approved applicants will then submit legal documents to the desired banks for acquiring the loan approval. The Banks will evaluate the applications and disburse the loan amount directly to the HEI in which the student has applied. The financial institutions will have the option to finance the safest loans and sell back the riskier ones to NEFC. Selling of loan portfolios will be on 'buy and hold' model rather than 'originate and sell'.

Guarantor: The government will determine the amount of overall budget and allocate it for the purpose of guarantee and cash resources available to repurchase loans from banks. The government will also include the cost of unemployment contingency and shall contribute towards financing the NEFC during the initial years of its inception.

Capital Market: The securitized loans will be issued as bonds to long-term institutional investors like insurance companies, mutual funds and pension funds. Student loans are long-term loans and hence the bonds will be issued to investors with long-term investment horizon.

5.1 Characteristics Of The Student Loan

5.1.1 Loan Design:

The loans issued to the students should be structured in such a way that they should be attractive not only to the students but also to the financial institutions involved. The structuring of loan should be suitable with respect to principal amount, term period, interest rate, payment schedule and administrative commission.

i. *Loan Amount*: Since the student loan will be structured to benefit students from lower income groups, loans should cover not only tuition fee but also transport and living expenses.

ii. *Term Period*: The term period of the loan will be decided by the government taking into consideration the average income range of graduates. A certain capping on the percentage of their monthly income can be ensured for repayment of installments. This will reduce the percentage of defaults. A longer loan repayment period is suggested as this will reduce default risk by reducing the financial burden on the student.

iii. *Moratorium Period*: In general, moratorium period for the student loans in India is, period of study plus 1 year or 6 months from getting a job, whichever is earlier. Hence the repayment period of the loan will begin after the study period is over. Incentive by way of reduced interest period can be given to the students who start paying the interest amount during the course of study.

iv. *Interest Rate and Administrative Cost*: It is important that the interest rate is not so low that it discourages private institutions. Additionally, commission which is a source of earning for the financial institution should also be optimal to ensure private participation.

v. *Guarantee*: Guarantees will play a crucial role of credit enhancement to attract large number of investors from capital market. Since the loan is meant to service students from lower income groups hence asking for partial guarantees from parents or guardians will defeat the social objective of this mechanism. This issue can be easily solved by way of CGF for education loan as proposed by GoI. In our proposed model, CGF will play the role of guarantor on behalf of MHRD to ensure that bondholders are paid their principal and accrued interests in an event of default of loan payments by students.

5.1.2 Securitization Role

The securitization model will be successful only if sizeable loan amount is pooled in. In the proposed model, NEFC will be securitizing loan portfolios coming from banks and the risky loan portfolios with NEFC itself. Once NEFC has acquired a critical mass of loans, which makes it economically viable to securitize, only then should issuance of bonds be done. It is important for the government to have included the financial cost borne by NEFC in the process.

6 CREDIT ENHANCEMENT MEASURES

6.1 Time Tranching & STRIPS

As the model matures and more investors participate in the securitization process, we can introduce Time Tranching to further sub-divide individual classes to attract more investors with a different risk-return preference. In our model, we propose use of STRIPS Bonds, which separate interest-only (IO) and principal-only (PO) elements to better address to a wider investor appetite. PO STRIP carries only the risk associated with timing of the cashflow (i.e. principal payment) & IO STRIP carry higher prepayment and interest rate risk. As a result this will address to risk appetite of both risk-averse and risk-lover investors.

6.2 Structural Protection Triggers (SPT)

In addition to the above structural credit enhancement measures, we propose inclusion of Structural Protection Triggers (SPT). Since the SPC does not have a ‘management’ inherent in it, securitization transaction should be able to self-modify its structure in case a problem arises. In SPT, in case of an event whereby the cumulative losses rise up to a certain percentage, then excess spread will be used to either create or increase the cash reserves.

6.3 Cash Reserves

It becomes imperative to have Cash Reserve Account in our structure in order to have SPT. The excess spread will be transferred to the Cash Reserve in case of ‘trigger’ in the structure. The originator will fund the ‘Reserve’ by retaining certain periodic principal and interest payments. The amount of cash required in the reserve account can be calculated as a percentage of Senior class or any other class. The reserve will be used only in a scenario wherein the securitization process does not perform well, wherein the cash reserve may be used to repay senior classes or both senior or subordinated classes. This aspect will be outlined in the legal document.

7 ADVANTAGES OF THE MODEL TO THE INDIAN ECONOMY

- *Importance of NEFC* : The incorporation of *NEFC* as a new system of advancing student loan will lead to simplification and progress in higher education sector in India. If NEFC is intertwined with securitization mechanism as mentioned above, it can reap economic and social benefits to the country. Further, a centralized body (NEFC) will guarantee equity in loan distribution. As the model grows, subsidiaries of NEFC can be set-up in each state.
- *Economic advantage:* In this set-up in case one region does not collect enough loan-pool, other regions can offset the deficiencies by contributing as a whole towards the entire system. Once the system as matured, every region can have its own SPV thereby contributing towards the financial market of that region as well.
- *Monoline insurance:* With growth of the securitization structure, government can issue laws and regulations supporting Monoline Insurance in financial sector as well. This will help in simultaneous growth of two sectors. With recent introduction of rise in FDI in foreign investment in insurance sector, more private players will be able to participate in the insurance business, leading to high growth in the sector. India has been recorded as the 9th largest insurance market in the world but what it lacks is market penetration, which is lower than some of its Asian peers. By promoting SLB securitization, market penetration can be increased by way of Monoline Insurance.
- *Economically Weaker Sections* : Easier and affordable availability of funding to students specifically from EWS by way of regionalized NEFC subsidiaries and income associated loan application selection.
- *Securitization not Privatization* : Government's role will be optimized as government will be providing guarantee by way of CGF and this will reduce the use of fresh cash resources which are always limited. Securitization will reduce the dependence on privatization wherein a majority shareholding is privately controlled. In are like HE, state control is paramount and securitization in HE sector will promote a system wherein the state remains the sole shareholder of all the shares and monitoring function is carried out by private sectors. Such a system is helpful in eliminating administrative inefficiencies common to the government while still exercising hard budgetary constraints of the government.
- *Growth of Indian Capital Market :* SLB securitization will lead to innovation in the securities market and growth of financial markets. As the model develops, incorporation of international agencies like International Finance Corporation can play the role of a partial guarantor, as it has been doing under its Partial Guarantee Scheme to have organizations make use of its higher credit rating.
- *Growth of Guarantee Agencies :* In many emerging economies like India, the economics of providing a solid credit guarantee is not that developed. Particularly in HE sector, guarantee agencies are nonexistent. By promoting CGF along with proposed securitization model, development of Guarantee Agencies can be promoted in India.

8 CONCLUSION

Securitization acts as an important link between capital markets and various industrial& manufacturing sectors. In recent times securitization got associated with negativity. It was not securitization but improper laws which led the industry to go out of control. With implementation of Basel III accord and various other protective laws, securitization is no more the evil it is usually considered.

The Government has failed to produce a structural framework for a solid credit market for higher education. With an enrolment rate as HEIs, as high as India's, a unique formula based approach needs to implemented. The proposed Student-Loan-Backed securitization model can reap great benefits to an emerging economy like India. However the government needs to implement appropriate legislations to regulate and promote the banking and capital market, if this securitization model is to show its true potential.