Securitisation and covered bonds for housing finance

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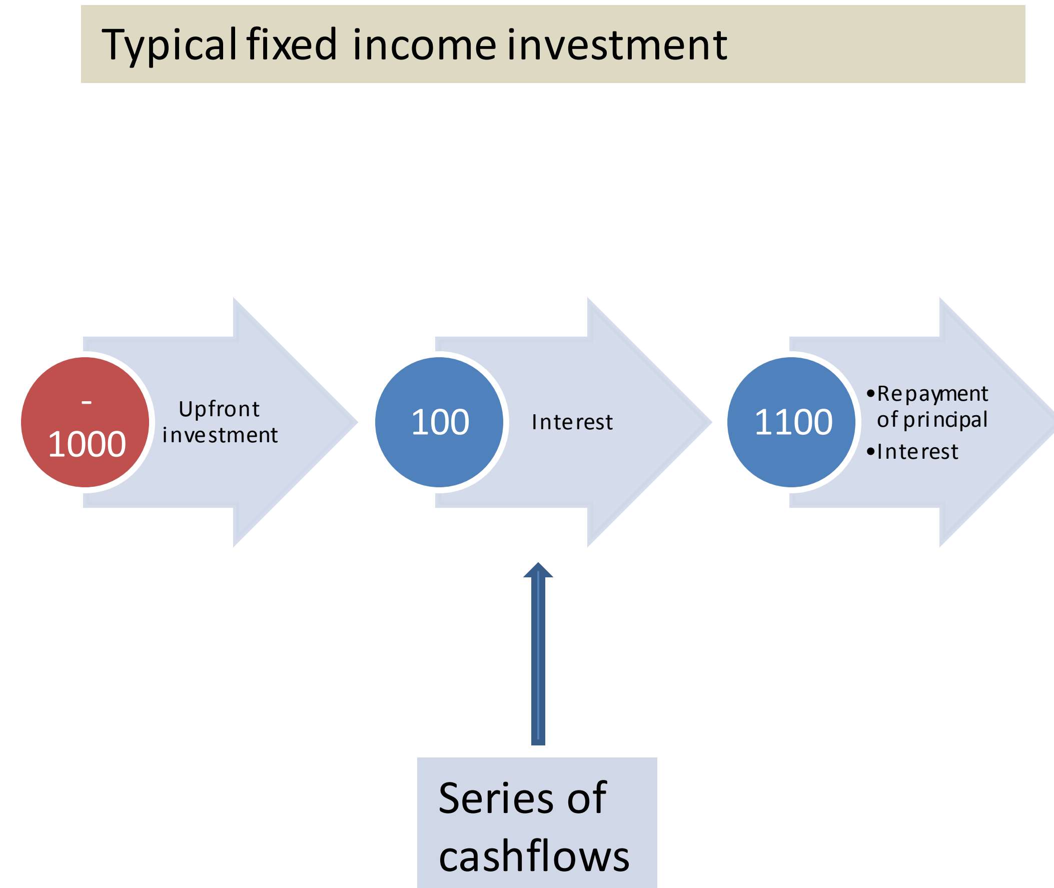
The intuitive idea of securitisation

- Housing finance lenders originate, hold and service mortgage loan portfolios.
- The loan portfolio can be envisaged as consisting of:
  - Origination
  - Servicing/recoveries
  - Financing
- The financing of a seasoned mortgage loan portfolio is a stabilised stream of cashflows, much similar to a typical fixed income instrument
  - Differentials:
    - Prepayment/curtailment behaviour
    - Periodic fluctuations due to delinquencies, advance payments etc
    - Defaults
- Hence the idea of transforming a mortgage loan pool into a fixed income investment option
  - Leading to what became known as “secondary mortgage markets”



History of securitization in the world

- 1970: Ginnie Mae issues first pass through
- 1981: Fannie Mae and Freddie Mac issue pass throughs
- 1983: First CMOs issued by Fannie Mae
- 1985: Sperry Lease Finance issues first ABS of computer leases
- 1990s: Non-agency CMOs grow
- 1993: Accounting Standard FAS 125
- 1996 onwards: sub-prime lending gets securitised
- 1999: synthetic transactions start appearing
- 2007: GFC hits; synthetic CDOs get ravaged; securitisation suffers

Securitisation in India

- Securitisation in India dates back to 1995-96:
  - Car loans were securitised by Citibank
- The market has seen substantial swings over time, mainly due to impact of regulation:
  - 1996-2006 was a period of rapid, unregulated growth. The period saw several interesting features:
    - Introduction of prepayment protected classes
    - A failed CDO issuance
    - Several loan sell offs to mutual funds where single loans were sold immediately after lending
  - 2006 – RBI regulates securitisation, leaves direct assignment out
    - Market shifted to direct assignments
  - 2011-12 – Income Tax Department chases several past transactions with mutual fund investors
  - 2012 – RBI Guidelines extent to direct assignments
  - 2013 – Income tax brings distribution tax to PTC transactions
  - 2016 – tax issues resolved; distribution tax replaced by withholding tax
  - 2018 – GST clarity, relaxation of FPI investment norms, PSL market shifts to PSLCs
  - 2019 – period of innovation and 100%+ growth in volumes

Key features of securitisation market in India
• A unique market where bilateral transactions (DAs) are also reckoned as a part of securitisation
• Large part of the market inspired by need for priority sector lending targets of banks
• NBFCs as major originators, banks as the investors for PSL-driven portfolios; virtually no issuance by banks
• Substantial impact of regulation and taxation in the shape, structure and dynamics of the market
• Insignificant activity in the RMBS space, except for intra-group transactions of affordable housing loans
• Substantially high levels of credit enhancements
• Most transactions, even if PTCs, are bespoke in nature and structured to suit specific investor
• Transactions mostly do not differentiate between

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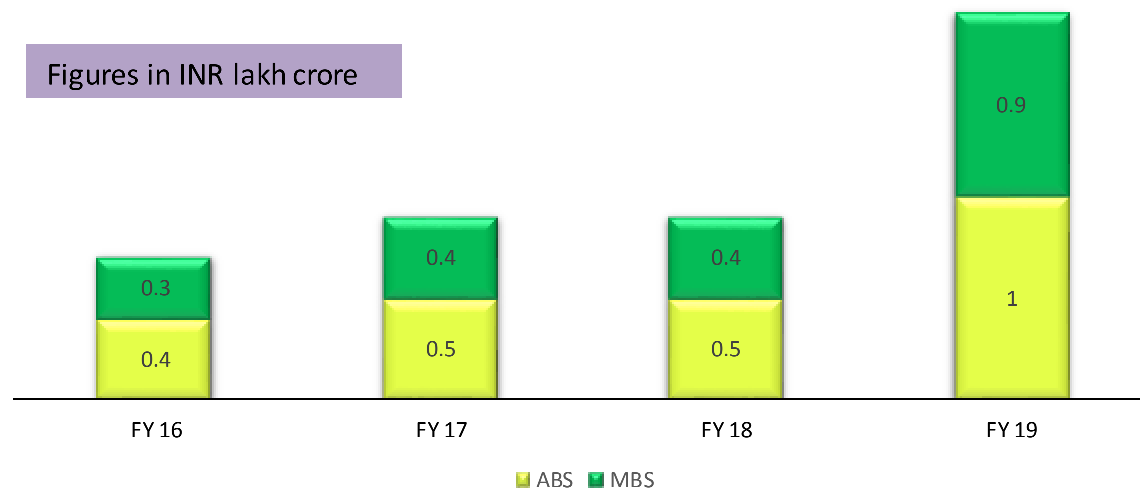
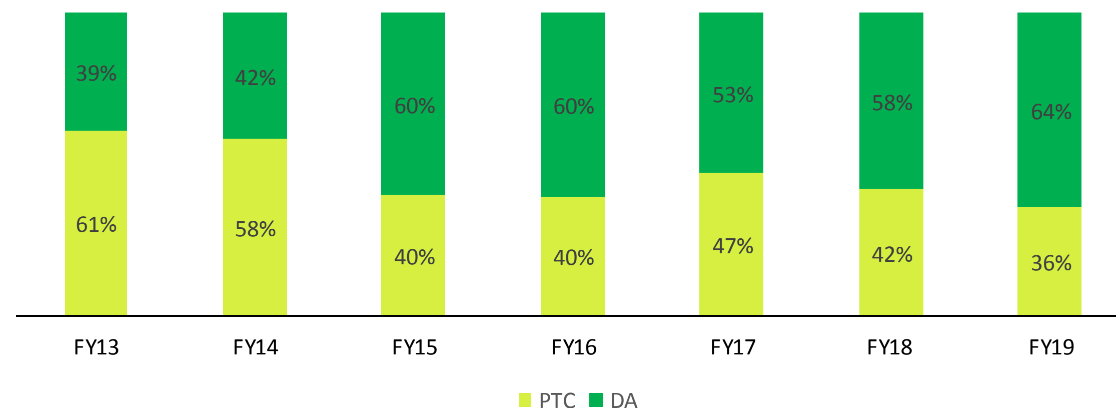
Volume of Securitisation in India

- FY 18-19 has shown a sharp increase in volumes:
  - Tax issues resolved in FY 16-17
  - GST clarity
  - Liquidity strain for several of the NBFCs – hence, securitisation/DA was the existential, rather than optional
- One may see a substantial jump in MBS-related securities too
  - Includes LAP as well as RMBS





Why RMBS activity in India is low?

- 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

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

Covered bonds and housing finance in India

- 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
  - Of course, it is not based on mortgage pool
- However, it is time for regulators to take notice and recognise covered bonds

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