MORTGAGE BACKED SECURITISATION AND THE SECONDARY HOUSING MARKET: INDIAN SCENARIO

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ABSTRACT

Housing Finance is an industry larger than the modern equity markets in India. It represents an industry with severe untapped potential, since the high demand for housing in India is met with funding and liquidity issues. Due to the high credit risk associated with housing loans, and a unruly default rate, there exists little incentive for banks and Housing Finance Companies to disburse loans. To offset this credit risk, the RBI, through its "Draft Framework for Securitisation of Standard Assets", seeks to develop secondary markets in India, for the pooling and securitisation of these loans, through Special Purpose Vehicles, using the underlying loans as collateral. While the development of such a secondary market would incite greater investment and disbursement of loans, the regulatory framework must also be wary of the failures of the United States secondary mortgage market, which led to the 2008 subprime crisis. The present article aims to discuss the incentives of Mortgage Backed Securitisation, its implications on banks and Housing Finance Companies and critically analyse the Draft Framework proposed.

INTRODUCTION

Housing is a fundamental concern for the citizens of a country. While it is a necessary requirement for basic human existence, it is also a valuable asset. In developing countries like India, that value is highly exemplified. With a high percentage of people living in metropolitan cities and an increased concentration of populations in urban environments, the sustainability of the modern housing infrastructure in India is a pertinent question. The Indian government has also increased its focus on the availability and maintenance of housing as a priority. This has been evident through fiscal and monetary measures undertaken by the government such as tax incentives for housing finance beneficiaries, more definite and taller budgetary outlays, and formation of the National Housing Bank (NHB) as an agency[1]. In addition to this, the government has recently issued declarations to achieve its ambitious goal of "Housing for All" by the year of 2022[2], through the "National Mission for Urban Housing".

The value of housing in India has been estimated to be around Rs. 150 lakh crores[3], an amount higher than the market capitalisation of current equity markets. However, despite this staggering figure, the current housing base has found to not meet the needs of the nation, either through a material shortage of accommodation, poor quality houses or a trend of increasingly unaffordable houses[4]; which begs the question, "How does the country acclimatise to the economic growth that is needed to address the needs of its citizens?"

One facet of the solution is the severely untapped potential of the housing finance market in India. Although a primary market, exists for Banks and Housing Finance Companies ('HFCs') to grant loans to prospective borrowers, it does not address funding and liquidity problems, and therefore exhibits an incomplete area for the government to capitalise on the high demand.

Market-Backed Securitisation (has been a widely used tool for allowing banks and Non-Banking Financial Companies ('NBFCs'), in various countries around the world, to offset their credit risk from these loan transactions, and to receive adequate funding. The operation of these securities is generally through a secondary market, that provides multiple benefits discussed

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[1] P. K. Manoj, *Dynamics of Housing Finance in India,* 75 THE JOURNAL OF INDIAN INSTITUTE OF BANKING AND FINANCE (IIBF) 19, 20 (2004).

[2] *"Housing for All by 2022" Mission– National Mission for Urban Housing* PMINDIA (October 14, 2020), https://www.pmindia.gov.in/en/news_updates/housing-for-all-by-2022-mission-national-mission-for-urban-housing/.

[3] Reserve Bank of India, Report of the Committee on Development of Housing Finance Securitization Market, (Issued on September 9, 2019).

[4] *Id*

further in this paper. The 2019 reports by the Harshvardhan led committee on "Development of Housing Finance Securitisation Market" and the task force on "Mortgage Backed Securitisation" have discussed potential problems in the current regime, made recommendations towards its enhancement, and suggested regulatory provisions for the same.

These recommendations have culminated in the recently issued "Draft Framework for Securitisation of Standard Assets"[5] to develop a regulatory framework for the development of secondary markets in India. The present paper is aimed to discuss the provisions and recommendation of the committees, and critically analyse them with due regard to the impact on the United States' secondary markets since the subprime crisis.

MORTGAGE BACKED SECURITISATION- WHAT IS IT AND WHY IS IT NEEDED?

Mortgage Backed Securitisation ('MBS') is the process of pooling multiple loans together, and transferring them along with their risk and interest to a third party, usually a Special Purpose Vehicle ('SPV'), that structures them together, and offers securities on those assets. Here the underlying collateral for the securities is the loan assets themselves. The entity offering the loans to borrowers, and subsequently transferring them to the third party is known as the 'Originator', and the entity that buys the securities offered on these loans is known as the 'Investor'. The payments of interest and principle on the underlying loan assets are transferred directly to the SPV, which in turn offers interest and payments on the securities.

The loans that are pooled by the SPV, usually exist in a multi-layer arrangement or credit derivative, made of "*tranches*" in which each tranche of loans is assigned a rating. Loans, that have a low possibility of default, are rated higher, by credit rating agencies. Similarly, loans that have a higher possibility of default, are rated lower and because of the higher risk associated with them, and therefore allow for higher returns to investors. These series of transactions operate in secondary capital markets independent of their underlying loans.

The process of securitisation offers multiple benefits to both the funding and liquidity structures of banks and HFCs, as well as to individual Investors, some of which include:

- Home loans usually present a significant challenge to lenders. This is because the maturity period of these loans is often much longer as compared to other traditional assets. Therefore, a mortgage with a maturity of 15-25 years presents a significant

[5] Reserve Bank of India, Draft Framework on 'Securitisation of standard assets, (Issued on June 8, 2020).

"Asset-Liability Mismatch" in the books of lenders, as compared to the relative short-term liability[6]. In relation, this problem is much more pronounced for HFCs, which do not have access to deposits and depend on bank borrowing as their prime sources of funding. MBS allows for these banks and HFCs to derecognise these loans from their books as a solution and settle them for cash inflow from the SPVs that are used to securitise the loans.

- Another benefit that securitisation offers also lies in the funding models of these banks and financial institutions. While banks usually have access to public deposits, the maturity terms for these deposits are more limited, where over 90 percent of all deposits mature within five years[7]. For HFCs, who as previously mentioned, do not usually have access to public funds through deposits, the lending is not sustainable. Here, securitisation can contribute by providing a critical source for funding for both these entities, as they as Originators can exchange illiquid mortgage assets for liquid cash, they receive through selling the underlying loans.
- There exists a higher need for alternative under-writing approaches to lending, and to encourage the same, securitisation offers a viable prospect. While low income and informal segments of the economy may require loans under ambitious urban development plans, or otherwise, these loans pose prepayment and capital risks to the banks and HFCs. Securitisation, therefore, permits these banks to offset their capital risks to private equity markets[8].
- By providing a "bankruptcy remote" transaction, securitisation of mortgage assets, provides security to mortgage pools from the possibility of insolvency of the Originator. Therefore, the value and rating of these assets, does not depend on the state of the Originator.
- In addition to this, there is an avenue to amplify the credit quality of the derivatives, through credit enhancement procedures, such as subordination and over collateralization. The risk transformation can be achieved by means of a structure in which certain tranches of securities are created to absorb losses from default[9]. Further,

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[6] Nishith M. Desai, Lubna Kably, *Asset Securitisation*, NISHITH DESAI AND ASSOCIATES (October 21, 2020), http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Asset_Securitisation.pdf.
[7] Elena Loutskina, *The Role of Securitization in Bank Liquidity and Funding Management*, 100 JOURNAL OF FINANCIAL ECONOMICS (JFE) 663, 667 (2010).
[8] Jacob Gyntelberg, Eli M. Remolona, *Securitisation in Asia and the Pacific: Implications for Liquidity and Credit Risks*, June 2006 BIS QUARTERLY REVIEW (BIS q. rev.) 65, 66 (2006).
[9] Nikhil Garg, *Understanding Credit Risk in Securitization and Measures to Build Effective Securitization Markets*, 14 IUP JOURNAL OF FINANCIAL RISK MANAGEMENT 45, 53 (2017).

any positive difference that arises between the payments received from the asset pool, and the committed cash outflow to the Investors, gives the originators an opportunity to meet any shortfall in payments to Investors.

- From the Investor perspective, MBS can provide a fixed income asset class with several benefits. In addition to low volatility, these highly liquid assets provide diversification. Moreover, these markets are countercyclical and usually have shown to benefit from a rise in interest rates, which serves to lower the risk of portfolios[10].

OUTCOMES FROM THE 2008 FINANCIAL CRISIS

While primary reasons for the crash have been indicated to be the usage of Credit Default Swaps ('CDS') in previous publications[11], the situation must be viewed realistically in order to prevent future crashes. It is important here to understand the role of loan Originators in the failure of the system, in addition to the overall fall of prices in the market.

Loan Originators play an important part in not only offering mortgages to prospective borrowers, but also the role of servicing those loans and monitoring the credit granting process. The loans cannot perform as collateral, if they are not of good quality, and the same needs to be ensured by the banks in their initial lending procedure, by ensuring the borrowers can actually pay the interest and principle of the loan itself.

In the situation preceding the crisis, regulatory requirements did not necessitate a Minimum Holding Period ('MHP') for these loans for the bank to monitor their credit worthiness or a Minimum Retention Requirement ('MRR') for them to maintain sufficient stake or "Skin in the game". In light of these, it is obvious that the banks had no incentive in maintaining the quality of loans, but only in issuing more loans on the basis of their originate-to-distribute model, which eventually led to mortgage pools deteriorating in actual value, due to pooling of subprime loans[12].

To offset their credit risk, the banks maintained the activity of transferring these asset pools to SPVs who arranged them into credit derivatives known as Collateralized Debt Obligations

[10] Henry Song, Douglas Gimple, *Benefits of Investing in Mortgage-Backed Securities*, DIAMOND HILL CAPITAL MANAGEMENT (October 24, 2020), https://www.diamond-hill.com/benefits-of-investing-in-mortgage-backed-securities/#:~:text=Mortgage%2Dbacked%20securities%20(MBS),which%20can%20lower%20portfolio%20risk.
[11] Rene M. Stulz, *Credit Default Swaps and the Credit Crisis*, 24 JOURNAL OF ECONOMIC PERSPECTIVES (JEP) 73, 83 (2010).
[12] John D. Martin, *A Primer on the Role of Securitization in the Credit Market Crisis of 2007* SSRN, (2009).

('CDOs'). Their second-tier pooling, and subsequent issuance of CDO squared (CDO^2) on such pools, led to a situation where any inevitable credit default incurring in the basic loan transactions, due to the nature of the subprime loans, was reverberated throughout the superstructure[13]. This, in tandem with pricing and rating delinquencies, led to an eventual crash.

The aftermath of the crash, one felt even in Indian Markets[14], saw the agency MBS offerings of Government Sponsored Enterprises ('GSEs') like Freddie Mac and Fannie Mae to be stunted with a complete collapse of private label offered MBS. The experience highlighted the need to find more effective ways to mitigate credit risk and avoid complexities in the securitisation process. In the present scenario, the United States has rebuilt its MBS markets in conformation with regulatory standards to prevent such complexities and have primarily adopted Credit Risk Transfer (CRT) programs to mitigate risk. To maintain their skin in the game, the rules require banks and HFCs to retain not less than five per cent of the credit risk on the mortgage assets[15].

While Residential Mortgage Backed Securitisation ('RMBS') models for Housing Finance markets have been previously upheld as highly stable and efficient structures to facilitate high liquidity and volume transactions[16], these models fail to suffice current economic requirements if proper compliance is not ensured[17].

REGULATORY AND LEGAL RECOMMENDATIONS BY THE HARSHVARDHAN COMMITTEE

Learning from the financial crisis, a major overhaul has evidently been sought by the RBI in the issuance of its draft framework for the regulation of the nascent MBS market in India, as is evident in the recommendations made by the Committee on the Development of Housing Finance Securitisation Market[18]. Various Legal and Regulatory Issues, with recommendations for Originators, Intermediaries and Investors. Some of these include:

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[13] Joseph R. Mason, Joshua Rozner, *How Resilient are Mortgage Backed Securities to Collateralized Debt Obligation Market Disruptions?* SSRN, (2007).

[14] Ridhi Bajoria, *Collateralized Debt Obligations in the Indian Financial Market*, GOA INSTITUTE OF MANAGEMENT (October 22, 2020), <https://voicesofgim.wordpress.com/2019/12/24/collateralized-debt-obligation-in-the-indian-financial-market/#:~:text=First%20introduced%20by%20Lewis%20Ranieri,be%20sold%20to%20the%20investors.

[15] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o).

[16] Vinod Kothari, Abhishek Gupta, *Development of RMBS markets in India: Issues and Concerns*, VINOD KOTHARI CONSULTANTS (October 20, 2020), http://www.vinodkothari.com/wp-content/uploads/2013/12/vk_rmbs_article.doc.

[17] Amol Agrawal, *Housing securitization in India- Build it block by block*, MONEYCONTROL.COM (October 12, 2020), https://www.moneycontrol.com/news/business/economy/housing-securitisation-in-india-build-it-block-by-block-4424331.html.

[18] *Supra* Note 3.

- Easing of necessary Stamp duty and registration requirements of mortgage pools[19], and identification of securities as essentially movable assets, unlike underlying loan assets to provide for a cheaper and more efficient registration and transfer procedure.
- Distinct regulatory treatment for Direct Assignment ('DA') and PTC (Pass-Through Certificate) transactions due to the fact that despite DA transactions require a transfer of loan asset pools from one entity to another, they do not include the issuance of securities.
- Separate regulation for MBS and ABS (Asset Backed Securitisation) transactions, due to the much stronger legal foundations of the underlying security in mortgage loans as compared to other asset types, and lower Loan-to-Value (LTV) ratios for home loans as compared to other classes of loans such as vehicle loans.
- MHRs and MRRs for banks to be slightly relaxed from 12 to 6 months, and from 10% to 5% respectively. To ensure sufficient "skin in the game" linking of the risk profiles on loan assets with the securities that are retained can be facilitated.
- Reduction in the credit enhancement reset period for underlying pool from 50 per cent repayment to 25 per cent repayment initially.

CRITICAL ANALYSIS OF THE DRAFT FRAMEWORK

With the introduction of the new framework, the RBI has decided to create a regulatory scheme which not only allows development of a strong and robust liquid secondary market in securitised assets, that follows international standards, like Basel III and IFRS guidelines[20]. The primary consideration for rethinking these guidelines has been to make the present market, which is a new one, transparent and vigil, and to avoid multi layered complex transactions to effectively safeguard the Indian market from manufacturing a similar crisis[21]. A few salient features of the framework are:

- Modification of the definition of "Securitisation" in conformation with an international understanding, with the inclusion of tranching. This is an effort in acknowledging the possibility of non-tranched portfolios containing bad debts which can pose major credit

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[19] The Registration Act, § 65, No. 16, Acts of Parliament, 1908.

[20] Adesh Sharma, Saksham Shrivastav, *Draft Framework for Securitization of Standard Assets: Re-modelling the Indian Securities Market*, INDIACORPLAW (20 October 2020), https://indiacorplaw.in/2020/07/draft-framework-for-securitisation-of-standard-assets-re-modelling-the-indian-securities-market.html.

[21] Loic Chiquier, Olivier Hassler, Michael J. Lea, Mortgage Securities in Emerging *Markets*, World Bank Policy Research Working Paper 3370, 10 (2004).

risks, and therefore in defining the scope of securitisation transactions to not include such portfolios.

- Bringing loan offerings to the pretext of a country with one of the largest agricultural sectors in the world[22], loans provided to individual borrowers for agricultural purposes, need to be verified in light of repayment of last two loans taken by the borrower. This protects the mortgage pools against possible credit default.
- Standardisation of practices by aligning the capital measurement approach with the Basel III framework of securitisation. The framework has provided two options of credit review and ratings to banks as mentioned in Basel III guidelines that are based on external ratings of exposure, which provides for prevention of rating delinquencies by agencies, a problem synonymous with the financial crash.
- An interesting proposition has found its way into the framework, of the introduction of Single Asset Securitisation (SAS) and Simple, Transparent and Comparable Securitisation (STC) reinstated from the 2006 guidelines themselves[23]. The proposition allows for broadening the scope of the securities market. Under this characterisation, Investors will be able to acquire loans through the secondary market itself[24]. These do not include any credit tranching or redistribution of risk.
- The MHP and MRR requirements for RMBS have been relaxed in conformation with the committee report previously discussed, due to the relative safety of residential mortgage as compared to other credit forms. Due regard has also been paid to the expected appreciation of the value of immovable property, which increases the lifetime of the overlying securities themselves, as a contributing factor in reducing the regulatory requirement.

With increased transparency from standardisation of the procedure, and an insurance for the servicing obligations of the Originator in securitisation transactions, it can be fairly concluded that the RBI framework aims to maintain keen oversight of MBS transactions.

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[22] Advait Rao Palepu, *RBI Sets the stage for listed residential mortgage-backed Securities*, BLOOMBERG QUINT (October 13, 2020), https://www.bloombergquint.com/business/rbi-sets-the-stage-for-listed-residence-mortgage-backed-securities.

[23] Reserve Bank of India, Guidelines on 'Securitisation of Standard Assets', Notification No. 2005-06/294, (Issued on Feb. 1, 2006).

[24] Amol Agrawal, *Fighting bad loans? A shift to markets from banks holds the cure*, MONEYCONTROL.COM (October 16, 2020), https://www.moneycontrol.com/news/business/economy/policy-fighting-bad-loans-a-shift-to-markets-from-banks-holds-the-cue-4416721.html.

Conclusion

Recent issuance of the RBI Draft Regulatory Framework for Mortgage Backed Securitisation, has shown an evolution of banking policy, with redefinition of familiar terms of securitisation, and policy measures aimed to address the regulatory and transparency challenges that a new MBS market could face in a developing country like India.

The proposed framework seeks out opportunities to increase the quality of transactions undertaken under the securitisation banner actively and introduces welcome regulatory changes to make the procedure more available to potential investors. While significant development must still be undertaken to overcome information differentials in such emerging capital markets[25], the framework moves to address present concerns of credit risk in a fairly new market. With a plan that can allow the future secondary securitisation framework to benefit from the observance of past failures in the United States market, The Indian Governments goals to create sustainable urban housing by 2022 present a worthy challenge for a high value prospective market.

[25] *Supra* Note 21