A STUDY ON ASSET SECURITIZATION GROWTH IN INDIA

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ABSTRACT

Asset securitization in India, initiated in the early 1990s with Citi Bank's pioneering transaction, has seen varied success due to numerous challenges. The process involves pooling various debt assets into tradable securities, allowing financial institutions to convert illiquid assets into liquid funds and transfer associated risks. This involves creating a Special Purpose Vehicle (SPV) to manage and structure the assets, which are then sold to investors who receive returns based on the asset's cash flows. Despite its potential benefits, including increased liquidity and capital raising, the Indian securitization market has struggled with regulatory complexities, market liquidity issues, economic volatility, operational constraints, credit rating challenges, tax inefficiencies, high transaction costs, and issues related to pre-payment of loans. A significant transaction in December 2019 by HDFC Bank demonstrated the viability of securitizing microfinance loans, signaling potential for growth. To enhance the success of securitization in India, clear legislative frameworks, improved market liquidity, increased investor education, and government support are essential. With these improvements, asset securitization could become a more robust and effective financial tool in India's economic landscape.

INTRODUCTION

Securitization in India was started at late 1990. The First securitization process was taken place at 1991 where Citi Bank raised Rs.16 Cr. From General Insurance Corporation of India by securitizing some of its auto loans. Between late 1990 and early 2000 the Asset Securitization got a momentum, by growing demand for structure Finance products.

Asset securitization in India operates through a trust structure where the assets transferred to trustee by sale. This arrangement done through special purpose vehicle which plays crucial role in securitization. Special purpose vehicle has two different kinds, one is pass through securities where the investors obtain a Beneficial Interest (cash flows) proportionally from the underlying assets and the other is pay through securities where the investors receive cash flow as per their payment schedule.

Though is has a structural process and potential benefit, it has faced numerous challenges which results in limited adoption and disappointing outcomes. As a result, this concept was not much successful in India.

Meaning of securitization

It is a financial process of pooling various types of contractual debt such as loans or receivables and converting them into tradable securities. The securities will be sold to Investors and they get returns based on the income generated from such assets. It helps to convert illiquid assets to liquid securities and also helps to raise capital and transfer the risk.

Meaning of Asset securitization

It is a process of converting illiquid assets into tradable securities. It helps to increase cashflow in the financial Institutions. It involves creating of SPV (special purpose vehicle) which hold assets, issue securities and sell it to investors.

AGENCIES REGULATING ASSET SECURITIZATION IN INDIA

1. SEBI

Securities and Exchange Board of India (SEBI) oversees the regulatory framework for securities. It ensures compliance with disclosures and protecting the interest of the Investors through SEBI (issue and listing of securitized Debt securities) regulations, 2008.

2. RBI

Reserve Bank on India (RBI) regulates securitization practices for Banks and Non-banking financial Institutions. It provides guidelines for asset quality and capital adequacy.

3. NHB

National Housing Bank (NHB) provides guidelines & regulations related to Securities of housing Loan through NHB (securitization of housing loans) Directions, 2010

PROCESS OF ASSET SECURITIZATION

1.Assset identification

Financial Institutions identify and separate the assets which can be securitized or eligible to issue as a security. i.e. which is often generating cash flow. All assets or debts cannot be securitized.

2.Creation of SPV

Financial Institutions create Special purpose vehicle (SPV) (i.e. it is a separate legal entity to isolate the financial risk associated with the Asset.

3.Transfer of Assets

Financial Institutions transfers the Assets to Special purpose vehicle. Transfer literally happens like a ‘true sale’ legally. The assets will be separated from Financial Institution’s balance sheet.

4.Structuring the securities

Special purpose vehicle structures the assets and converts in into securities (bonds). Securities has different types of risks and return policies.

5.Credit rating

To attract the investors and for high returns, the securities will be rated by Credit Rating Agencies. The high rates assets will have low risk and vice versa.

6.Sale of securities.

SPV sell the securities to investors. The Investment amount will be credited to Financial Institutions

7.Payment to Investors

Cash flow generated are distributed to the investors as per the terms of the securities and at the time of redemption, the investors get full payment which is principal and interest.

REASONS WHY THE SECURITIZATION PROCESS IS NOT MUCH SUCCESSFUL IN INDIA

1.Regulatory & legal challenges

Though Reserve bank of India and Securities Exchange Board of India issues several guidelines, frequent changes & updates creates complicity. No clear definitions for the terms of such as true sale & bankruptcy remoteness.

2.Market liquidity issue

Secondary market in India was not well developed. It makes difficulty for investors to buy & sell the securities easily. Only institutional investors can participate in the market. Retail investors have a limited role in market.

3.Economic environment

The uncertain economic downturns lead to higher default rates, impacting the performances of securitized products.

4.Operational challenges

Creation of SPV and transfer of assets needs high infrastructure & technologies which Financial Institutions cannot invest in these.

5.Credit ratings

Credit enhancement mechanisms such as over-collateralization & third-party guarantees needs significant cost and if ratings are lower, the investors will not show interest in buying.

6.Tax treatment & double taxation

Lack of clear tax treatment for securitized assets. Some times it results in double taxation. for ex. SPV has to pay tax for the income they have generated and the investors also has pay to tax for the profit they have received from the SPV which leads to double taxation.

7.High stamp duty cost

The stamp duty in transferring of assets from financial institutions to SPV was quite high and it leads to increase in overall cost of securitization transaction.

8.Pre-payment or refinance of Loans

When the borrower decides to pay the loan before the scheduled period, the interest for the loan get reduced, so the amount of income the investors receives also get reduced. This also happens when the borrower refinances their Loan to any other institution for low interest rate.

2008 CRISES AND ASSET SECURITIZATION

Asset securitization was a major factor in the 2008 financial crisis. This process involves putting together different types of debt, like mortgages and car loans, and selling them as investments. Leading up to the crisis, banks used this method a lot, often in risky ways, which helped create a housing bubble. They turned risky mortgages into investment products and sold them to investors. When home prices dropped and people started missing mortgage payments, these investments quickly lost their value. This caused huge losses for both investors and banks. The heavy reliance on securitization, combined with poor regulation and risky lending practices, made the crisis much worse, leading to a major global financial meltdown.

OVERVIEW OF HDFC BANK'S SECURITIZATION OF MICROFINANCE LOANS

December 2019, HDFC- one of the India's largest private banks completed successfully s securitization transaction involving microfinance loans. It is the significant transaction both in terms of size and its impact.

The approximate amount of transaction is INR 1,376 Cr. (USD 193M). The participants are HDFC Bank and various Finance Institutions. For structuring the securities microfinance loans was transferred to SPV, then the securities were issued. The transaction was well-received, indicating the strong confidence in the underlying assets and the Securitization structure.

SUGGESTIONS

1.There must be clear and unambiguous legislation framework for the securitization process.

2. To enhance market liquidity, developing the secondary market in India for securitized products is needed.

3.To Increase the participation in investing on securitized assets, the Investors has to be provided with awareness and Education about the Securitized liquidated assets.

4.The assets which are stable and generate continuous cash flow has to be securitized for high success rate and to create good name among investors.

5.Government should support securitization process by providing incentives or favorable policies as much as possible.

CONCLUSION

Asset securitization was a major factor in the 2008 financial crisis. This process involves putting together different types of debt, like mortgages and car loans, and selling them as investments. Leading up to the crisis, banks used this method a lot, often in risky ways, which helped create a housing bubble. They turned risky mortgages into investment products and sold them to investors. When home prices dropped and people started missing mortgage payments, these investments quickly lost their value. This caused huge losses for both investors and banks. The heavy reliance on securitization, combined with poor regulation and risky lending practices, made the crisis much worse, leading to a major global financial meltdown.