

Why RBI's new draft frameworks are path-breaking for banking sector

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Draft frameworks on securitisation of standard assets and sale of loans are path-breaking for the banking sector.



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Two important draft frameworks put out by [RBI](#), on securitisation of standard assets and on sale of loans, are quite path-breaking as they move the system towards the market. In a way, financial intermediation moves towards the market. Anything in the market tends to be more transparent, and hence, is an improvement as it feeds back into the system of sanctioning loans.

So far, securitisation has functioned in a limited perimeter, with stressed assets and retail loans going under such packaging. Now, with the framework being laid down for all standardised assets, there will be better pricing also in the market, which will be a collateral benefit. The same holds for sale of loans, where it will now be possible for one bank to originally give the loan and then sell to another within the guidelines set for the players.

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The major advantage here is that the buying and selling of the security in the bond market is replicated in a different form here. At a mature stage, the loan market can mimic the bond market where there are continuous trades taking place. The advantage for the selling bank is that it can tune its balance sheet to the overall changing risk appetite and maturity preference. Hence, relatively riskier assets can be sold off at a discount to stabilise the balance sheet, and just like how there is continuous ALM in banks, the same can hold for the loan portfolio. The buyer of the loan or security would also be matching the asset to the available risk appetite and tenure.

Second, based on how the market evolves, banks would have to be probably more careful when lending because taking on risk which cannot be passed on will ensure that good behaviour prevails. Hence, as seen in the latest episode in the BFSI space, taking on undue risk will not make sense as it will not be able to pass it on to other institutions. Or even if there is appetite for the same, the discount at which it will go will be quite deep, which affects the P&L.

Third, following from the above, such a market will lay the foundation of the development of a junk bond market. Currently, in India, such a market does not exist, and hence it will be a case of the bank loan market leading to its development. As buyers of high-risk assets (which will go at a substantial premium) increase in number, it would be possible for a parallel market to develop in the bond market, which will be useful for the system as this has been one of the objectives to create markets for lower-rated securities with high yields. Therefore, the fructification of securitisation of standard assets and sale of loans can be a useful precursor for the junk bond market to evolve.

Fourth, an active market for sale of loans will lead to finer pricing. Right now, there are internal risk models used by banks to price loans. As banking is often a relationship business, there is considerable negotiation involved in pricing of the loan. While this has worked well in the past, things will change once there is a secondary market where the price is determined by the interplay of banks rather than being unilaterally fixed. This will, interestingly, address the issue of transmission of interest rates in the system, which, it is believed, is quite sticky. In a way, the central bank policy rate transmission will be tested by the market; the suasion being used today to make it more efficient may not work. The market will decide.

Fifth, the credit rating agencies (CRAs) will be a critical piece here, for the buyer of any loan or security would like to have an independent assessment of the concerned financial instrument. While securitisation does involve such a rating, even for sale of loans there should be a rating provided on the residual maturity, besides the initial rating provided at the time of evaluation. This fresh rating would need to be separately tracked by CRAs till maturity. But this is very essential for the final pricing in the market where it assumes the role of a critical input. In fact, unlike the primary loan disbursed where the price is based on a rating (internal), in this case the secondary market pricing will vary according to the rating reviews of an external CRA.

Sixth, the sale of loans is a modified version of take-out finance, which was the solution mooted for the infra sector where a bank that gives a loan for a 20-year project moves out after a fixed time period by selling the same to another bank, which could be on pre-specified terms. This way, the ALM gets balanced for all the concerned parties. The sale of bank loans may be looked as a market solution to the problem of rolling over of loans. It is very progressive for the system.

It would also be interesting to see if these instruments would lead to an increase in lending. This can be a big plus for the system as the risk-taking ability could also increase where banks would lend knowing that they can exit after some point of time. While the line between prudent and aggressive risk will have to be sorted out in the guidelines that are finalised, typically in the initial stages there would be caution exercised for sure. It is only when the market develops fast that this problem can arise. This was the case with the sub-prime crisis where the concept of securitisation involving CDOs, MBS, CDS, etc, inspired higher risk-taking by financial institutions.

Finally, a well-developed market for these two assets can also trigger some action on the CDS front. The CDS is fairly moribund in India for a variety of reasons. With these markets for bank loans evolving, the logical corollary would be to have some protection being offered on loans in the form of insurance. This is where one can see potential for the CDS market where such an opportunity would arise and can be taken as a trigger. On the whole, there are exciting times ahead for the Indian banking system.

The author is chief economist, CARE Ratings. Views are personal



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