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SECURITIZATION STRUCTURES AND FINANCIAL STABILITY

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Abstract

Securitization has traditionally acted as a vehicle that distributes credit risk and facilitates balance sheet efficiency in the financial system. In India, securitization has been institutionalized by the SARFAESI Act of 2002, which is based on the transfer of financial assets to asset reconstruction companies. The asset transfer approach helps to align ownership, enforcement, and investment interests, hence promoting transparency and financial stability.

Synthetic securitization, on the other hand, refers to another type of credit risk transfer in which the underlying exposures stay on the balance sheet of the originating entity but the credit risks are transferred using derivatives like credit default swaps. Though synthetic securitizations have been extensively used in several advanced financial markets to improve capital efficiency and diversify risks, there are certain issues concerning complexity, lack of transparency, and capital arbitrage involved in such transactions.

The current paper evaluates the institutional and regulatory status of synthetic securitization from the perspective of financial stability in the Indian financial sector. Synthetic securitization is not part of statutory securitization since the former lacks an asset transfer element, thus making synthetic securitization a form of prudential regulation by the Reserve Bank of India that is skeptical about derivatives-based forms of credit risk transfer.

Through an analysis of the differentiating features between traditional securitization and synthetic securitization, economic logic of securitization, and risks to financial stability from both traditional securitization and synthetic securitization, the current paper seeks to establish that there is a deliberate bias in the Indian legal regime against synthetic securitization in favor of traditional securitization.

Key Words: Securitization, synthetic, RBI, SARFAESI Act, credit default swap.

I. Introduction

Securitization has become a key financial tool used by financial institutions to improve balance sheet efficiency and redistribute credit risk. Securitization in its traditional form entails the transfer of financial assets from original banks to special purpose organizations, which subsequently issue securities that are backed by the underlying asset pool. Through this process, relatively illiquid loan exposures can be converted into tradable instruments that investors can hold. Securitization in India has mostly grown within the legal framework created by the SARFAESI Act[1151], which makes it easier for distressed financial assets to be transferred to asset reconstruction firms for recovery and restructuring[1152].

International financial markets have created alternative methods of transferring credit risk in addition to conventional securitization models, most notably synthetic securitization. Synthetic

[1151] Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002.

[1152] Steven L. Schwarcz, The Alchemy of Asset Securitization, 1 Stan. J. L. Bus. & Fin. 133 (1994)

structures do not necessitate the transfer of the underlying financial assets, in contrast to traditional securitization. Rather, the assets themselves stay on the originator's balance sheet while the credit risk associated with a portfolio of exposures is transferred through derivative instruments like credit default swaps or credit-linked notes. These structures have been employed in a number of sophisticated financial systems as a way to distribute credit risk within financial markets and manage regulatory capital requirements.

However, different jurisdictions handle synthetic securitization in very different ways. While some financial systems have incorporated synthetic securitization into their prudential regulatory frameworks, the regulatory approach in India has remained extremely cautious. The transfer of financial assets and the alignment of ownership, enforcement rights, and investor participation through asset reconstruction companies have historically been at the center of the institutional architecture of securitization under Indian law. Regarding the institutional placement of synthetic securitization within the Indian financial regulatory framework, this poses a significant legal question.

Taking the case of synthetic securitization, this paper investigates the connection between securitization structures and financial stability within the Indian regulatory framework. It examines how the structural features of synthetic securitization vary from those of conventional asset-transfer-based securitization models, as well as the effects these variations have on the distribution and control of credit risk in the financial system. In doing so, the study assesses whether synthetic securitization has a unique institutional position within Indian financial regulation or if it can function within the statutory securitization architecture established under the SARFAESI Act. In order to place synthetic securitization within the larger conversation on securitization structures and financial stability, the analysis also examines how concerns about transparency, regulatory capital integrity, and systemic risk have influenced the Reserve Bank of India's cautious regulatory approach.

II. Statutory Architecture of Securitization Under SARFAESI Act, 2002

A. Statutory Framework of Securitization

The SARFAESI Act provides for a securitization model which is generally called 'traditional securitization' or 'true sale securitization'. The legislative intent behind the statutory architecture of securitization provided under SARFAESI Act is recovery directed. Increasing Non-Performing Assets in banks and financial institutions led to this coming in force of this Act. Constitutionality and the purpose of recovery were upheld in the Supreme Court case of Mardia Chemicals Ltd vs Union of India[1153] where SARFAESI was identified to be an instrument that allowed for efficient enforcement of security interest without involving courts. The Act, through its traditional securitization model, aims at strengthening the enforcement capacity of banks and financial institutions. The Act provides for the establishment of special purpose vehicles or special purpose entities called securitization companies or reconstruction companies, which have to be registered with the Reserve Bank of India. These securitization companies or reconstruction companies are commonly referred to as Asset Reconstruction Companies (for brevity, 'ARC'). This function of ARCs as specialist organizations that acquire financial assets for restructuring purposes was highlighted again in the Supreme Court case of Phoenix ARC Pvt Ltd vs Vishwa Bharati Vidya Mandir[1154]. The securitization model under SARFAESI Act provides for these ARCs to acquire the assets from the banks or financial institutions, authorized under Section 5 of the Act[1155]. This section is the trigger for securitization under the Act. The acquisition of financial assets by the ARCs may be done through either an agreement for transfer or through issuance of

[1153] Mardia Chemicals Ltd. v. Union of India, (2004) 4 SCC 311.
[1154] Phoenix ARC Pvt. Ltd. v. Vishwa Bharati Vidya Mandir, (2022) 5 SCC 345.
[1155] Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, No. 54 of 2002, § 5 (India).

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bonds, debentures or securities in consideration for the acquisition. Following the acquisition, the legal consequence of it is, the transfer of ownership as well as incidental enforcement powers over the financial assets, from the bank or financial institution to the ARC. Therefore, the securitization model under SARFAESI Act is triggered by acquisition of financial assets and is presumed on the actual transfer of the loan form the balance sheet of the bank or the financial institution to that of the ARC.

1. **Funding mechanism and investor participation**

The recovery-oriented structure of traditional securitization is further strengthened by Section 7 of the SARFAESI Act[1156] which permits the ARCs to issue security receipts to qualified institutional buyers (for brevity, 'QIBs'), only after acquisition of the financial asset as per Section 5. These security receipts represent an undivided interest of the respective QIB in the financial assets that have been acquired, and these security receipts are issued under specific schemes formulated by the ARCs. The realization from such financial assets are to be applied towards the redemption and payment of investment and returns, respectively, under the relevant scheme. Thus, under this model, investor participation is directly linked to the performance and recovery of the acquired assets.

2. **Reconstruction and enforcement powers**

Additionally, under Section 9 of the Act[1157], ARCs are granted reconstruction and enforcement powers, which include the ability to reschedule debt, settle dues, enforce security interests, and convert debt into equity. Ownership and control of the underlying financial asset are prerequisites for these powers. The asset-based enforcement regime is well recognized in case law, specifically in Transcore v Union of India[1158], wherein it was held that "SARFAESI gives an independent process of enforcing the secured interest outside of conventional recovery proceedings." The ARC takes on legal authority to manage and recover the asset in addition to facilitating risk redistribution.

When combined, Sections 5, 7, and 9 show that the Act's securitization model is essentially recovery-driven and asset-transfer based. Ownership of the financial asset, investor returns and control over enforcement are all structurally linked. Securitization is not considered by the statutory framework as a method of merely transferring abstract credit risk apart from asset ownership.

3. **Structural features and financial stability**

Financial stability is clearly impacted by the structural design of securitization under the SARFAESI Act. To begin with, banks can improve their capital positioning and operational focus by transferring distressed financial assets to the regulated ARCs, which allows for balance sheet cleansing. Further, since investor returns are directly connected to identified acquired assets and their recoveries, the issuance of security receipts under scheme-based structures guarantees asset pool transparency. Additionally, because the entity holding the financial asset, that is the ARC, also has the authority to restructure or enforce it, the alignment between asset ownership and enforcement powers under Sections 5 and 9 lessens legal fragmentation. Together, these characteristics show a securitization model intended for controlled management of distressed assets within a regulated institutional framework, rather than just generating liquidity. This strategy has also found acceptance in the judicial field, as evident from the case of United Bank of India v. Satyawati Tondon[1159], where the Supreme Court placed stress on limiting judicial involvement in matters relating to the SARFAESI Act.

[1156] Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, No. 54 of 2002, § 7 (India).
[1157] Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, No. 54 of 2002, § 9 (India).
[1158] Transcore v. Union of India, (2008) 1 SCC 125.
[1159] United Bank of India v. Satyawati Tondon, (2010) 8 SCC 110.

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Global financial markets have also created alternative methods of transferring credit risk, even though the SARFAESI framework creates a securitization architecture based on the transfer of financial assets and enforcement rights. According to ICICI Bank Ltd v Official Liquidator of APS Star Industries Ltd[1160], the Supreme Court upheld that the securitization is an exercise of transferring financial assets, which constitutes a proper banking operation, thereby cementing the importance of asset transfer under the law. However, synthetic securitization is a method that allows institutions to transfer credit risk without transferring ownership of the underlying asset. Before analyzing how these instruments are regulated under Indian law, it is important to comprehend their structure and economic justification.

Collectively, these interpretations of Indian judiciary clearly prove that the process of securitization in India basically depends upon the actual transfer of financial assets as well as rights of collection. It, therefore, cannot be compared to any type of synthetic securitization.

III. Structural Architecture of Synthetic Securitization

Synthetic securitization has been developed and used as a sophisticated mechanism for credit risk transfer in several advanced financial markets like those of the United Kingdom and the European Union. However, its structural feasibility, depends largely upon the surrounding legal as well as regulatory framework. Conversely, India has taken a different path. India only allows for actual transfer of loans, especially stressed loans, rather than allowing for derivative-based risk transfer. The Indian ecosystem focuses on removing the bad loans from the balance sheets of the bank and thus cleaning the balance sheets through asset transfer, rather than derivative contracts.

As already discussed at length in the previous section of this paper, the traditional securitization model in India involves actual transfer of distressed assets from the bank to the ARCs under the SARFAESI framework. The model revolves around the principle of true sale of assets where the ownership as well as the enforcement rights over the underlying pool of loans move from the originating bank to the acquiring entity

However, the synthetic securitization structure operates quite differently. Instead of actual transfer of the loans, the originating bank retains the assets on its balance sheet and only transfers the credit risk associated with those assets to a third party through complex financial instruments such as Credit Default Swap (for brevity, 'CDS') contracts.

A. Financial Mechanics of Synthetic Securitization

To have a clearer understanding of the synthetic securitization structure, it is requisite to first understand the financial mechanics of a synthetic securitization transaction. In a synthetic securitization, the originator bank transfers the credit risk of an underlying pool of loans to a protection seller via credit derivatives or guarantees. In this framework, the loans do not leave the balance sheet of the originator and there is no transfer of ownership or enforcement rights over such assets. This is also called balance sheet synthetic securitization transaction. In simplest terms, it could be said that synthetic securitization functions as a hedge against the loan default[1161]. Rather than actually transferring the ownership and enforcement rights over the underlying assets, the bank only enters into derivative contracts such as a CDS to insulate the loan from the risk of default. Through such derivative contracts, the originator transfers the credit risk in the underlying assets to a third party called the protection seller. The originator pays a premium to the protection seller, who, through the contract, agrees to cover the credit risk and pay and compensate the originator in case a specified credit event like that of a borrower

[1160] ICICI Bank Ltd. v. Official Liquidator of APS Star Industries Ltd., (2010) 10 SCC 1.

[1161] Reserve Bank of India, Master Direction – Securitisation of Standard Assets Directions, 2021, Direction 5(y).

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default occurs. Therefore, through this securitization transaction, the originator is able to retain the loan on its balance sheet while simultaneously mitigating a potential loss arising from a deterioration in the credit quality of the underlying exposure.

B. Regulatory Definition under RBI Framework

The Reserve Bank of India (for brevity, 'RBI') had issued Master Directions on Securitization of Standard Assets Directions on September 24, 2021 defining synthetic securitization. Under Part B Direction 5(y) of the RBI Master Directions, synthetic securitization is defined as:

"a structure where credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of credit derivatives or credit guarantees that serve to hedge the credit risk of the portfolio which remains on the balance sheet of the lender;"[1162].

Synthetic securitization structures are quite complex. It usually involves three indispensable elements: the originator (which is usually a bank or a financial institution), the protection seller (investor) and the reference portfolio of assets. The originator does not sell the portfolio of assets to the ARCs rather retain it on its balance sheet. The credit risk is transferred by the originator by selling it to the protection seller using credit derivative instruments in exchange for the originator paying a premium to the protection seller. This enables the originator to keep the asset on its balance sheet while also relying on the fact that if circumstances are created where this risk is actualized, the bank will be insulated as the protection seller will compensate it for the agreed portion of losses.

The structural mechanics is the first step towards understanding the synthetic securitization structure. However, it is imperative to understand the economic incentives that drive the use of such complex structures. Rather than using synthetic securitization as merely a risk-hedging mechanism, many advanced jurisdictions also utilize it as a tool for optimizing the regulatory capital requirements imposed on banks.

Beyond its structural design, financial institutions' exposure to specific economic and regulatory incentives led to the development of synthetic securitization in international financial markets.

IV. Economic Rationale of Synthetic Securitization

A. Capital Optimization and Bank Incentives

The ability of financial institutions to enhance their regulatory capital requirements[1163] while keeping the underlying loan exposures on their balance sheets is one of the main economic drivers of synthetic securitization. Banks must maintain capital proportionate to the risk-weighted value of their assets under international prudential frameworks like Basel III. The Basel III framework has included stricter bank capital adequacy requirements following 2008 crisis. It significantly increased the capital banks are required to hold against risk-weighted assets[1164]. However, through synthetic securitization mechanism, banks can lower the regulatory capital required to be held against specific exposures by transferring the credit risk associated with those exposures through derivative contracts, most frequently a CDS[1165]. In addition to maintaining current lending relationships and generating income from the underlying assets, this allows institutions to manage balance sheet risk more effectively. This fits in well with the idea that the motive behind securitization is more about achieving regulatory capital relief than about raising funds.

B. Credit Risk Distribution in Financial Market

Beyond the incentive of capital relief to the banks, synthetic securitization also enables banks to have a broader credit risk distribution

[1162] Reserve Bank of India, Master Direction – Credit Derivatives Directions, 2022.
[1163] Vinod Kothari, Securitisation: Should India Move to the Next Stage of Development? (2019).
[1164] Basel Committee on Banking Supervision, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (2011).
[1165] Basel Committee on Banking Supervision, Revisions to the Securitisation Framework (2014).

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across the financial market. Banks can diversify their credit portfolios and lower concentration of risks by shifting exposure to investors who are prepared to take on such risks. Investors with different risk appetites can participate in certain structures where the transferred risk is divided into distinct tranches and referenced by instruments like Credit-Linked Notes.

C. Investor Participation and Risk Exposure

Synthetic securitization provides investors with access to credit exposures that might not be possible in conventional debt markets. Pension funds, insurance firms, and asset managers are examples of institutional investors that frequently take part in these transactions by taking on a specific percentage of the credit risk connected to a reference portfolio of loans. They get a recurring premium in exchange, which represents the securitized exposures' underlying credit risk. Investors can diversify their investment portfolios across various asset classes and industries while earning a credit risk premium with the help of this structure. The wider distribution of credit risk within the financial system is thus made possible by synthetic securitization transactions, which serve as risk-sharing agreements between banks and capital market players[1166].

Notwithstanding these financial benefits, substantial regulatory concerns have been raised by the structural complexity and opacity of synthetic securitization transactions. In particular, regulators in a number of jurisdictions have adopted a more cautious and strictly regulated approach toward complex structured credit products due to their role in exacerbating systemic vulnerabilities during the 2008 Global Financial Crisis.

In light of the possible threats to financial stability, synthetic securitization has drawn a lot of regulatory attention despite these economic benefits.

V. Financial Stability Implications of Synthetic Securitization

As a direct result of its dual effects on financial stability, synthetic securitization has sparked a great deal of discussion in the field of financial regulatory scholarship. Even though these arrangements can help financial institutions spread credit risk and improve capital efficiency, if they are not properly regulated, they may also create new types of systemic vulnerability.

A. Stability-Enhancing Aspects of Synthetic Securitization

The argument that synthetic securitization structures can help the banking system manage credit risk more effectively is frequently used to support them. The capacity of such transactions to serve as a credit risk hedging mechanism is one of their main benefits. Banks can reduce the risk of possible losses resulting from borrower default while keeping the underlying assets on their balance sheets[1167] by shifting the credit risk associated with a portfolio of exposures to investors through credit protection instruments like credit default swaps or credit-linked notes. This makes it possible for financial institutions to better manage portfolio risk without upsetting their current lending relationships with borrowers.

Capital optimization is a significant economic incentive for synthetic securitization. Banks must maintain regulatory capital commensurate with the risk-weighted value of their assets under international prudential frameworks like Basel III. By transferring some of the credit risk associated with specific exposures to outside investors through synthetic securitization, banks can lower the risk-weighted value of those assets and free up regulatory capital that can be used for other lending initiatives[1168]. Thus, while adhering to capital adequacy regulations, synthetic

[1166] PGGM & PFZW, Simple Synthetic Securitisations: Why and How We Invest in Synthetic Balance Sheet Securitisations (2015).
[1167] Giuseppe Macchitella, Synthetic Securitisation as a Bank Capital Optimization Tool and the Impact of International Regulation (Master's Thesis, 2016) Page 17.
[1168] Giuseppe Macchitella, Synthetic Securitisation as a Bank Capital Optimization Tool and the Impact of International Regulation (Master's Thesis, 2016) Page 17-18.

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securitization may improve banks' ability to provide credit to the real economy.

B. Systemic Risks: Complexity, Opacity and Capital Arbitrage

Synthetic securitization may have benefits, but because of its complexity and possible effects on financial stability, these structures have also sparked serious regulatory concerns. The structural complexity[1169] of synthetic securitization transactions, which frequently involve several contractual layers like credit derivatives, reference portfolios, and tranche-based risk distribution, is one of the main issues[1170]. Regulators and market participants may find it challenging to precisely determine the final distribution of credit risk within the financial system as a result of these structures.

Regulators have, additionally, voiced concerns about the potential for regulatory capital arbitrage in synthetic securitization structures as well as misaligned incentives. Institutions may be motivated to structure such transactions primarily to optimize regulatory capital requirements rather than to achieve a true transfer of credit risk because synthetic securitization enables banks to obtain regulatory capital relief while keeping the underlying loan exposures on their balance sheets. Banks must maintain capital in proportion to the risk-weighted value of their assets under prudential frameworks like Basel III. Banks may be able to lower the amount of capital required to be held against specific exposures by using credit derivatives to transfer the credit risk associated with those exposures while keeping the underlying assets. This technique, which is often referred to as capital arbitrage, enables organizations to economically retain a significant amount of the underlying risk while technically adhering to regulatory capital standards[1171].

From a regulatory standpoint, these arrangements might make prudential capital frameworks less effective. The originating institution may continue to be indirectly exposed to the same credit risk that the capital relief assumes has been transferred if the risk transfer incorporated in the derivative contract is insufficient, ill-designed, or reliant on counterparty performance. During the Global Financial Crisis[1172], these worries, along with the structural complexity and opacity of synthetic securitization products, contributed to wider systemic vulnerabilities[1173]. As a result, regulators in many jurisdictions adopted more cautious approaches toward these instruments.

The regulatory positioning of synthetic securitization in the Indian legal system raises significant concerns. Synthetic securitization operates through derivative-based credit risk transfer while the underlying exposures stay on the originator's balance sheet, in contrast to traditional securitization structures governed by the SARFAESI Act through the transfer of financial assets. Because of this structural difference, its institutional position within the Reserve Bank of India's regulatory framework must be examined.

VI. Institutional Position of Synthetic Securitization in Indian Law

Examining whether such transactions are governed as prudential credit risk transfer mechanisms under RBI's regulatory supervision or fall under the statutory securitization architecture established under the SARFAESI Act is necessary for the institutional placement of synthetic securitization within the Indian legal framework.

While Asset Reconstruction Companies' acquisition of financial assets is the foundation of the SARFAESI Act's securitization model, synthetic securitization structures function through a mechanism which is fundamentally different all together. Under such arrangements,

[1169] PGGM & PFZW, Simple Synthetic Securitisations: Why and How We Invest in Synthetic Balance Sheet Securitisations (Position Paper, 2015).
[1170] Gary B. Gorton, Slapped by the Invisible Hand: The Panic of 2007 (2010).
[1171] Basel Committee on Banking Supervision, Revisions to the Securitisation Framework (2014).
[1172] Financial Stability Board, The Global Financial Crisis: Causes and *Lessons* (2009).
[1173] PGGM & PFZW, Simple Synthetic Securitisations: Why and How We Invest in Synthetic Balance Sheet Securitisations (Position Paper, 2015).

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only the associated credit risk is transferred through derivative contracts or credit protection mechanisms. However, the underlying loan exposures remain on the originating bank's balance sheet. This structural difference brings up a crucial institutional question in the Indian legal system: can such risk-transfer arrangements be accommodated by the statutory framework governing securitization under the SARFAESI Act?

A. Inapplicability of SARAFESI Framework

The premise that the securitization structure within the SARFAESI Act is based on is actual acquisition and transfer of financial assets. Examining the connections between Sections 5, 7, and 9 of the Act makes this structure clear. By enabling banks and other financial institutions to transfer financial assets to ARCs, Section 5 serves as the main catalyst for securitization under the Act. Following such an acquisition, Section 7 permits ARCs to provide security receipts, which represent an undivided interest in the acquired financial assets, to qualified institutional buyers under particular schemes. These clauses work in concert with Section 9, which gives ARCs a variety of enforcement and reconstruction authority over the assets that they have acquired.

Given that the underlying financial assets are not transferred, synthetic securitization structures do not trigger this statutory architecture. Under such arrangements, only the related credit risk is transferred through derivative contracts or credit protection mechanisms, leaving the originating bank with ownership of the loan exposures on its balance sheet. As a result, the subsequent procedures pertaining to the issuance of security receipts under Section 7 and the use of reconstruction powers under Section 9 are also inapplicable, and the statutory trigger envisioned under Section 5 does not materialize. Therefore, an asset-transfer based model of securitization is required by the SARFAESI framework, while synthetic securitization uses risk transfer instead of asset transfer.

Therefore, the regulatory treatment of synthetic securitization in India must fall under the purview of prudential banking regulation, which governs credit risk transfer and capital adequacy, rather than the statutory securitization framework established under the SARFAESI Act.

B. Prudential Regulation under RBI

Even though synthetic securitization has financial benefits, different jurisdictions treat it very differently. The Indian regulatory approach has remained noticeably cautious and rather conservative, despite the fact that a number of developed financial markets have progressively integrated synthetic securitization into their prudential frameworks. As the main regulator of banking and securitization operations, the RBI has always placed a high priority on balance sheet integrity and structural transparency in the financial system. As a result, true sale securitization mechanisms, in which the underlying financial assets are moved off the originator's balance sheet, have been the main focus of the regulatory framework governing securitization in India. Therefore, synthetic securitization structures have a very limited place in the Indian regulatory framework because they rely on derivative-based credit risk transfer without a corresponding transfer of the underlying asset.

The regulation of synthetic risk transfer or synthetic securitization structures falls within the realm of prudential banking regulation governed by the RBI. Securitization transactions undertaken by banks and financial institutions are majorly regulated by Master Direction – Reserve Bank of India (Securitization of Standard Assets) Directions, 2021.

As already discussed, Part B, Direction 5(y) of the RBI Master Direction defines synthetic securitization as a structure in which the credit risk of an underlying pool of exposures is transferred, either entirely or partially, through the use of credit swaps or credit guarantees that

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act as a hedge for the credit risk of the portfolio that stays on the lender's balance sheet[1174].

However, the RBI has taken a restrictive approach towards synthetic securitization transactions in India. Part A under Chapter II of the Master Directions provides for the assets available for securitization. Direction 6 of Part A lists out the securitization operations that lenders, including foreign branches of banks are prohibited from undertaking. This list under sub-direction (c) includes synthetic securitization. Thus, the RBI, through its Master Directions has explicitly prohibited lenders from undertaking synthetic securitization activities. The RBI's regulatory preference for true sale securitization structures in which ownership of the financial asset and the related credit risk are transferred out of the originator's balance sheet is reinforced by the prohibition.

A more general prudential concern about the potential for regulatory capital arbitrage and systemic opacity is reflected in the regulatory ban on synthetic securitization. Banks can transfer the credit risk associated with a pool of assets without actually transferring the underlying assets thanks to synthetic securitization structures. Financial institutions may be able to lower their regulatory capital requirements without significantly changing the economic risk associated with the exposures, even though this mechanism may offer originators capital relief under specific regulatory frameworks. The RBI has always been wary of these kinds of arrangements, especially in view of the systemic weaknesses exposed during the 2008 Global Financial Crisis, when sophisticated synthetic securitization instruments significantly increased financial instability.

Furthermore, the Indian financial system has regulatory restrictions on the derivative instruments that are commonly used to enable synthetic securitization transactions. Building portfolio-based credit risk transfer structures is made more difficult by the Reserve Bank of India's Master Direction on Credit Derivatives[1175], which primarily limits the use of credit derivatives to single-name credit default swaps. These regulatory restrictions further restrict the viability of synthetic securitization structures in India because they typically necessitate the pooling of various exposures and the transfer of portfolio credit risk through derivative instruments like credit default swaps or credit-linked notes.

Taken together, these regulations show how the Indian legal system views synthetic securitization as a matter of prudential banking regulation rather than as a securitization activity in the traditional sense. The Indian regulatory approach places a higher priority on structural transparency and balance sheet integrity than other jurisdictions that incorporate derivative-based credit risk transfer mechanisms into securitization markets. The RBI has effectively restricted the growth of synthetic risk transfer structures within the domestic financial system by maintaining restrictive conditions on credit derivatives while expressly forbidding synthetic securitization under the Securitization of Standard Assets Directions. In order to protect financial stability and avoid regulatory capital arbitrage, the regulatory framework thus reflects a conscious policy decision to favor true sale securitization and direct asset transfer mechanisms over derivative-based credit risk redistribution.

Although a cautious approach to synthetic securitization is evident in the Indian regulatory framework, the underlying regulatory issues are closely related to more general concerns about financial stability. Because of their structural complexity, opacity, and reliance on derivative-based credit risk transfer, synthetic securitization structures have historically been linked to serious systemic risks, despite the fact that they can provide some economic and risk management advantages. Therefore, analyzing

[1174] Master Direction - Reserve Bank of India (Securitisation of Standard Assets), Directions, 2021

[1175] Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022

the possible effects of such structures on the stability and resilience of the financial system is necessary to comprehend the regulatory treatment of synthetic securitization.

VII. Conclusion

This paper's examination demonstrates the close association between financial stability concerns and the structural design of securitization mechanisms. The distribution of credit risk within the financial system, the transparency with which risks are distributed among market participants, and the efficiency with which regulatory frameworks may govern such transfers are all determined by securitization structures. The regulatory preference for mechanisms that preserve asset ownership transparency and enforcement rights is reflected in the statutory architecture governing securitization in India, which has historically given priority to structures based on the transfer of financial assets

A structurally distinct method of transferring credit risk is synthetic securitization. Synthetic securitization separates the economic risk of default from the legal ownership of the asset by enabling institutions to transfer credit risk through derivative instruments while keeping the underlying exposures on their balance sheets. These structures add more layers of complexity, opacity, and potential incentive misalignment, even though they may give financial institutions tools for regulatory capital optimization and balance sheet management. These traits have received a lot of attention in relation to the systemic weaknesses that emerged during the Global Financial Crisis[1176], when intricate mechanisms for transferring credit risk led to more widespread financial instability.

The SARFAESI Act's securitization architecture, which aligns asset ownership, enforcement authority, and investor participation within a single institutional structure, is based on the transfer of financial assets to asset reconstruction companies. This statutory securitization framework is not activated by synthetic securitization since it does not entail the transfer of underlying exposures. Rather, it falls under the purview of the Reserve Bank of India's prudential banking supervision, which has taken a cautious approach to credit risk transfer mechanisms based on derivatives.

From the standpoint of financial stability, this regulatory approach shows a conscious policy preference for securitization structures based on real asset transfer and institutional clarity as opposed to artificial redistribution of credit risk through derivative contracts. The Indian regulatory framework aims to guarantee that securitization remains a transparent method of managing distressed assets and balance sheet risks without creating new systemic vulnerabilities in the financial system by upholding this structural emphasis.

[1176] Gary B. Gorton & Andrew Metrick, Securitized Banking and the Run on Repo, 104 J. Fin. Econ. 425 (2012).

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