Why loans should become tradeable instruments?

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Today any loan is a bilateral transaction between a bank and the borrower; and the amount and rate at which it is given is reckoned based on the relative bargaining power between the two. The bank has its internal models which is topped by considerations such as sector exposure, company or group name and exposure, management quality etc. To this may be added the rating given by an external credit rating agency. The borrower has a choice of going to different banks for the same loan and would hence choose the one where the deal is the best. Where it is consortium lending the dynamics would change but the broad pattern would be the same.

Such loans are fairly opaque and rarely does the deposit holder or the shareholder know the portfolio of a bank. Hence the risk taken by the bank is unknown. Interestingly most bank borrowers would be in the sub-investment category and may not have access to the bond market which is typified by higher rated companies which would be above "A" credit rating. But banks use collateral and also have a strong relationship with the customer and hence the transaction works well.

In this situation is there a case for making a bank loan a tradeable instrument? Normally any market is a platform for efficient price discovery and hence making a loan a part of this system has the advantage of better pricing. Therefore, having a secondary market for loans will help determine the right price or rather interest rate which in turn will feed back into the otherwise opaque primary market which is a bilateral transaction. Just as it is seen the equity market where the secondary market price has a bearing on the price that can be commanded in the market for fresh issuances, the same will hold here too. So better pricing is the first advantage of having such tradeable instruments. It would also mean that these loans have to be mandatorily rated by an external credit rating agency so that potential buyers are aware of the credit worthiness of these instruments.

Second, banks can continuously rebalance their portfolio depending on the situation. Exposure to certain sectors may be lowered or increased by selling off loans in the market and using the same capital to lend to other companies. The price discovery process would automatically bring all the players together and achieve this goal. Hence, if a bank wants to shift asset exposure from power to food processing, the former loans can be sold in the market and the funds be used for either a fresh loan to a food processing company or could be a secondary market purchase too. This would be an efficient way of all banks rebalancing their books.

Third, bank may like to adjust their risk weighted portfolio; and in this context would be keen on selling off those which are tending to the upside of the curve. The secondary market would help such transactions as there would be counter parties that would have a higher risk appetite that would be scouting for the same. Therefore, rather than hold on to dodgy assets a sale could help them. This in fact would also help at a mature stage for selling NPAs in the market where the buyer could be a bad bank or an asset reconstruction company or even a NBFC. This system will help banks clean up their asset portfolio and can be a potential solution for the NPA issue. The market hence should be open for all players in the financial system and RBI and SEBI can make an inclusive list of the same.

The growth of a secondary market for banks loans will be a precursor to the development of the CDS (Credit Default Swap) market which is virtually moribund in the country. The reason for a placid market is that the corporate debt market is one for higher rated paper which virtually has a low probability of default. Hence there is no reason for any 'insurance' to be taken on AAA or AA rated paper especially so if the issuers are large financial institutions and PSUs. But if a secondary market for loan develops which encompasses even lower rated loans which are considered riskier, it will intuitively also help to build a junk bond market in the country.

A junk bond market is one where lower rated companies raise funds from the market at a higher cost. Today it is not possible given the low appetite for the same. In western countries it has been observed that the probability of default of junk bonds is not very high and in the range of 4-7% and hence could be a risk worth taking for institutions that have a higher risk appetite. But once a CDS market evolves in the loans segment there would automatically be buyers of lower rated-higher yielding bonds which in turn will widen the scope of the debt market. It is now accepted that the future of finance for growth which is primarily for long term investment including infrastructure lies in the corporate bond market. For the market to evolve we need more sellers of paper and requisite buyers. Buoyancy in the CDS market would bring in these players and help the market grow. This in turn will help the banking sector too as the long-term finance involving loans of 10-20 years will move to the debt market and the banks will be better able to manage their asset-liability mismatches. Therefore, it is a win-win situation for everyone.

Are there are downfalls? Having a secondary market for banks loans which is akin to the securitization process needs also its regulation in place. The process of originate and distribute which was the pitfall in the securitization business that went into making Lehman happen has to be ringfenced in the banking context. This is so because banks may take on riskier loans with less due diligence and then sell off the asset in the market knowing very well that it will no longer be on their books after a while. This temptation will be there during the yearend when targets have to be met when such loans are sanctioned. The risk is in not finding a buyer for these loans which can create a problem for the originating bank. Therefore, there need to be strong internal risk policies on the same which is approved and monitored by the Board Committee.

Bankers may not be too comfortable with this system to begin with because they would lose their discretionary power on pricing of loans as the secondary market rates would automatically create benchmarks.

The other conundrum would be more on the accounting side in case the entire portfolio has to be valued at the end of the year. Once there is a market value of a loan, which can be higher or lower, then logically the balance sheet size of a bank gets affected and just like how the investment portfolio gains and losses have to be accounted for, there need to be guidelines on these loans too as there will be substantial fluctuations. Banks may have to probably classify loans into the HTM, AFS and AFT categories just like in case of government bonds to get the valuation right and book the losses.

It can be said that the time has come to create such a market and the RBI has opened up the channels for discussion with the draft papers on such markets in place. It can be seen to becoming a reality in say another 12 months or so with the present pandemic related issues causing deferment of such action. The test would however be in terms of responses of banks and other participants as more transparency comes into play. While one cannot be sure of the success of this market, it definitely will add a very interesting and potentially dynamic segment that will help in growing the banking system and making it vibrant.

Views are personal