STRUCTURED FINANCE RATINGS

June 2020

Proposed securitisation guidelines can widen participation in the securitisation market

Abhishek Dafria
+91 22 6114 3440
abhishek.dafria@icraindia.com

Sachin Joglekar
+91 22 6114 3470
sachin.joglekar@icraindia.com

Mukund Upadhyay
+91 22 6114 3411
mukund.upadhyay@icraindia.com

Himanshi Doshi
+91 22 6114 3410
himanshi.doshi@icraindia.com

Proposed securitisation guidelines can widen the participation in the Indian securitisation market

On June 8, 2020, the Reserve Bank of India (RBI) issued a draft regulatory framework for securitisation and sale of loans. The RBI has sought to separate the regulations for securitisation and for direct assignment (proposed to be now treated as sale of loan exposure). The proposed guidelines aim to widen the market participation in securitisation transactions and loan sell-down.

- Market for residential mortgage backed securities would benefit with the downward revisions of minimum holding period and retention ratio as well as earlier reset of credit enhancement as compared to other asset classes.
- Loans purchased from other lenders can also be securitised which would increase the extent of securitisable assets.
- Introduction of STC (simple, transparent and comparable) transactions would provide the benefit of lower risk weights.
- Removal of minimum retention ratio requirement from loan sell down could lead to further preference for direct assignment over securitisation
- Clarity, however, would be required on some areas such as derecognition of transferred assets and calculation of the minimum retention ratio.

This note provides a comparative snapshot of certain key parameters of the existing and the proposed guidelines[1].

EXHIBIT 1. Comparative snapshot of the guidelines: Securitisation of standard assets

Parameter	Existing guidelines	Proposed guidelines	Remarks
Assets eligible for securitisation	On-balance sheet standard exposures, except the following: a. Revolving credit facilities b. Assets purchased from other entities c. Securitisation exposures d. Loans with bullet payments of both principal and interest	On-balance sheet standard exposures, except the following: a. Revolving credit facilities b. Securitisation exposures c. Loans with bullet payments of both principal and interest	Proposed guidelines plan to allow loans purchased from other lenders to be securitised as long as a 12-month period has elapsed since the loan purchase. The step would increase the extent of securitisable assets and thus provide liquidity, but may find limited usefulness in the current market setup as banks who typically purchase loans are not engaged much in securitisation of their assets. The stance of regulator remains unchanged with respect to other asset

[1] The note does not cover the guidelines proposed to be introduced for sale of stressed assets

Parameter	Existing guidelines	Proposed guidelines	Remarks
			classes that are still not allowed to be securitised.
Securitisation of single loan exposure	Not allowed	Allowed	As per the revised definition for securitisation, even a single loan exposure can be securitised which had been common before they were disallowed as per the 2012 guidelines.
Minimum Holding Period for residential mortgage backed securities (RMBS)	Twelve months MHP for loans with original maturity greater than 5 years (had been reduced to six months as a temporary relief measure in September 2018, and the latest extension is till June 2020)	Six months or a period covering six instalments, whichever is later	We have already seen housing finance companies (HFCs) make use of the temporary relaxation on MHP provided by the RBI over the last 18-month period. A permanent reduction in MHP will enlarge the market for RMBS transactions for the long run and increase the liquidity of the HFCs in home loans and affordable housing finance.
Minimum Retention Ratio for residential mortgage backed securities (RMBS)	10% (had been increased to 20% if the above mentioned MHP relaxation was to be used)	5% of the book value of the loans being securitised	The reduction in MRR is significant at 5% as against the temporary increase to 20% for loans securitised with above mentioned lower MHP. This would free up cash for the HFCs, though it remains to be seen whether investors would be agreeable to lower MRR in the transactions.
Reset of Credit Enhancement (CE)	The transaction documents required explicit mention of the CE reset clause for the reset to be undertaken	In case a CE reset clause was not incorporated in the original documents, the reset of CE may be undertaken subject to the consent of all investors of outstanding securities	The suggested changes will make securitisation more lucrative for originators, especially those involved in RMBS. Originators in RMBS transactions, that are of a long tenure, will now be able to seek reset

Parameter	Existing guidelines	Proposed guidelines	Remarks
	Reset can be done after minimum principal amortisation of 50% for all asset classes	Reset can be done after minimum principal amortisation of 25% for RMBS and 50% for all other asset classes	of CE at an earlier date as compared to previous guidelines and also at an increased frequency (which is also true for other asset classes) which can improve the economics behind the transactions. The new guidelines continue to maintain that only upto 60% of the CE which is allowed to be released by the rating agencies can be actually released, thus maintaining further cushion to safeguard the credit quality going forward.
	Minimum gap of one year required between successive resets for transaction with tenure > 5years	Minimum gap of six months should be maintained between successive resets for all transactions	
	Minimum 30% of initial CE amount must be maintained	Minimum 20% of initial CE amount must be maintained for RMBS transactions and 30% of initial CE amount for other asset classes	
Replenishment structures	No mention	Transaction structures involving replenishment of the pool of receivables at certain intervals will require to clarify on the all aspects of amortisation, triggers, termination	While a few replenishment structures exist in the market, the explicit clarity on the same through the guidelines could result in more originators and investors willing to explore such transactions which typically helps in creating a longer tenure transaction from short-term receivables.
Mandatory listing	No regulation for mandatory listing	Mandatory listing for RMBS transactions with pool outstanding of minimum Rs. 500 crore	The mandatory listing of RMBS transactions may not have a material impact in the near term other than adding to the transaction costs. It would also lead to greater compliance requirements. While, in theory, listing can improve the secondary market for the securities and hence appeal to a wider investor base, the reality is that there are several hurdles to secondary market trading of RMBS papers, such as tenure uncertainty owing to high and volatile prepayment rates, interest rate risk (or basis risk), and an absence of a variety in investor categories.

Parameter	Existing guidelines	Proposed guidelines	Remarks
Classification of securitisation transactions	No classification	Transactions classified into STC (simple, transparent and comparable) and non-STC	Based on certain criteria being met, securitisation transactions can be classified as STC which would carry lower risk weights. The guidelines, however, need to clearly mention the criteria for non-STC transactions too as many points would overlap.
Accounting treatment	Realised gain from securitisation is amortised over the tenure of the transaction (though this underwent a revision once Ind AS guidelines were adopted)	Realised gain from securitisation is to be recognized upfront	Proposed revision would align the RBI's guidelines to the prevailing Ind AS provisions
Capital adequacy and Risk Weights	Exposure by the originator beyond 20% in the transaction is to carry a risk weight of 1111% for banks and 667% for NBFCs	Exposure by the originator beyond 20% in the transaction is to carry a risk weight of 1250%	The proposed guidelines make no distinction between entities with different regulatory capital requirements (banks, HFCs and NBFCs). This would be a negative for NBFCs.
	Risk weights are linked only to the rating of the securitisation exposure	Risk weights to be determined either through Securitisation External Ratings Based Approach (SEC-ERBA) or Securitisation Standardised Approach (SEC-SA). Under SEC-ERBA approach, risk weights are determined on basis of - i) STC compliance; ii) Seniority of tranche; iii) Tenure of the tranche.	The risk weights for high rated senior tranches have been reduced (lowest risk weight is 10% for AAA-rated senior tranche of a STC-compliant transaction) compared to the current risk weights being followed, though the junior tranches – especially A-rated and below – carry much higher risk weights. The latter may not be in alignment with the rating agency's approach of viewing tranches with the same rating as having the same probability of default, irrespective of their seniority (which is already considered while assigning the rating). Overall pricing scenario could undergo a change from the current levels.

Parameter	Existing guidelines	Proposed guidelines	Remarks
	NBFCs are not mandated to have a rating-based risk weight assigned for securitisation exposures	NBFCs are mandated to have a rating-based risk weight assigned for securitisation exposures	The change would benefit NBFC investors of high rated securitisation exposures

EXHIBIT 2. Comparative snapshot of the guidelines: Sale of loans (Standard Assets)

Parameter	Existing guidelines	Proposed guidelines	Remarks
Assets eligible for loan sell down	A single standard asset or a part of such asset or a portfolio of such assets through an assignment deed, except the following: a. Revolving credit facilities b. Assets purchased from other entities c. Securitisation exposures d. Loans with bullet payments of both principal and interest	A single standard asset or a part of such asset or a portfolio of such assets through an assignment deed, except the following: a. Revolving credit facilities b. Securitisation exposures c. Loans with bullet payments of both principal and interest	The change is similar to the one proposed under securitisation guidelines covered in Exhibit 1
Minimum Retention Ratio (MRR)	5% for loans with original maturity upto 24 months and 10% otherwise	There is no mandatory requirement to retain any portion by the originator. Also, the upper limit on the retained portion has been removed.	Although the mandatory requirement is removed, the proportion of retention can be mutually decided by the lender and originator. It is quite likely that investor may insist on reasonable MRR so as to ensure quality of pool sold by the originator, especially for newer originators, whereas established originators may be able to enter into transactions without any retention ratio. If investors do not seek MRR to be kept by the originator, then such originators may favour loan sell down as against securitisation to free up their liquidity.

ICRA notes that further clarification would be needed from the RBI in certain sections of the guidelines so as to cover definitions of new terms used, remove ambiguity and clarify the intent behind some of the proposals. Some of these sections where clarification is needed are highlighted below.

EXHIBIT 3. Salient points requiring clarification

Definition of securitisation	As per the definition given in the guidelines, only transactions with multiple tranches would qualify to be called securitisation. However, a majority of the securitistion transactions at present have a single tranche structure. How would one account for such structures?
Meeting requirement for Minimum Retention Ratio (MRR) in securitisation	At present, the cash collateral (sometimes referred as 'credit enhancement' in the guidelines) maintained by the originator is considered towards MRR requirement. However, as per the proposed guidelines, the MRR requirement is being met only through exposure in subordinate tranches in the structure. Would the cash collateral no longer be accounted under MRR?
Definition of first loss and second loss exposure	First loss exposure and second loss exposure are mentioned in the guidelines for evaluating the MRR but are not defined in the 'Definitions' section. A clear definition would help in understanding the conditions set for MRR.
Derecognition of transferred assets	In order to derecognize the transferred assets under securitisation, significant credit risk has to be transferred. The condition stipulated for structures with at least three tranches would be easy to comply (risk-weighted exposure amounts of the mezzanine tranche held by the originator should not exceed 50% of the risk-weighted exposure amounts of all mezzanine tranches existing in this securitisation). However, for structures without a mezzanine tranche (which are more common), the originator is not allowed to hold more than 20% of the first loss position which would result in difficulty in meeting the MRR for the originator and in also finding an investor to invest in the remaining 80% of the first loss position. For example, if the senior tranche and junior tranche (i.e. first loss position) are split in 90:10 ratio, the originator will be able to invest in only 2% of the junior tranche (i.e. 20% of 10%) and would have to invest in say 8% of the senior tranche to meet MRR of 10%. The primary investor in the senior tranche is unlikely to be interested in investing in the junior tranche which would thus raise the requirement for a new investor for the remaining 8% exposure in the junior tranche. However, ICRA believes the intent of RBI would have been to allow the originator to invest in the junior tranche upto 100% such that the total exposure does not exceed 20% of the securitised pool.
Classification of pooled loan assets under the Government's Partial Credit Guarantee Scheme	Under the Partial Guarantee Scheme announced in August 2019, credit enhancement was allowed to be provided for loan sell down which otherwise was not permitted. The Scheme has been recently extended until March 31, 2021. It might be prudent to now clarify the regulations that would apply for loans sold under the said Scheme so as to provide clarity on certain aspects like reset of credit enhancement.

ICRA
A MOODY'S INVESTORS SERVICE COMPANY

ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

Alliance with Moody's Investors Service

The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder. The participation of Moody's is supported by a Technical Services Agreement, which entails Moody's providing certain high-value technical services to ICRA. Specifically, the agreement is aimed at benefiting ICRA's in-house research capabilities, and providing it with access to Moody's global research base. The agreement also envisages Moody's conducting regular training and business seminars for ICRA analysts on various subjects to help them better understand and manage concepts and issues relating to the development of the capital markets in India. Besides this formal training programme, the agreement provides for Moody's advising ICRA on Rating-products strategy, and the Ratings business in general.

The ICRA Factor

Our services are designed to

- Provide information and guidance to institutional and individual investors/creditors;
- Enhance the ability of borrowers/issuers to access the money market and the capital market for tapping a larger

ICRA

Business Contacts

Mr. L. Shivakumar
E-mail: shivakumar@icraindia.com
Tel: +91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee
E-mail: jayantac@icraindia.com
Tel: +91 80 4332 6401/ +91 98450 22459

Media and Public Relations

Ms. Naznin Prodhani
E-mail: communications@icraindia.com
Tel: +91 124 4545 860

Registered Office:

1105, Kailash Building, 11th Floor,
26, Kasturba Gandhi Marg,
New Delhi - 110 001
Tel: + 91 11 2335 7940-45

Corporate Office:

Building No.8, 2nd Floor,
Tower A, DLF Cyber City Phase II,
Gurgaon- 122 002
Tel: +91 124 4545300

Ahmedabad

1809-1811, Shapath V,
Opposite Karnavati Club
S.G. Highway, Ahmedabad - 380015
Tel: +91 79 4027 1500/01

Bengaluru 1

'The Millenia', Tower- B, Unit No. 1004,
10th Floor,1 & 2 Murphy Road,
Bengaluru - 560 008
Tel: +91 80 4332 6400

Bengaluru 2

2nd Floor, Vayudooth Chamber,
15-16, Trinity Circle, M.G. Road,
Bengaluru - 560 001
Tel: +91 80 4922 5500

Chennai

5th Floor, Karumuttu Centre,
634, Anna Salai, Nandanam
Chennai - 600 035
Tel: +91 44 4596 4300

Hyderabad 1

No. 7-1-58, 301, 3rd Floor, 'CONCOURSE',
Above SBI-HPS Branch, Ameerpet,
Hyderabad - 500 016
Tel: +91 40 4920 0200

Hyderabad 2

4A, 4th Floor, SHOBHAN,
6-3-927, A&B Somajiguda,
Raj Bhavan Road,
Hyderabad – 500082
Tel: +91 40 40676500

Kolkata

A-10 & 11, 3rd Floor,
FMC Fortuna 234/3A,
A.J.C. Bose Road,
Kolkata -700 020
Tel: +91 33 7150 1100/01

Mumbai

3rd Floor, Electric Mansion
Appasaheb Marathe Marg,
Prabhadevi,
Mumbai - 400 025
Tel: +91 22 6169 3300

Pune

5A, 5th Floor, Symphony,
S. No. 210 CTS 3202 Range Hills Road,
Shivajinagar,Pune - 411 020
Tel: +91 20 2556 0194, 020 6606 9999

Email: info@icraindia.com
Helpdesk: 9354738909
Website: www.icra.in/ www.icraresearch.in