ICRA

STRUCTURED FINANCE

Credit profile of ICRA-rated MBS pools expected to remain stable amidst increasing interest rates: ICRA

MAY 2022

Highlights

ICRA

Click to Provide Feedback

With the onset of increasing rate cycle, following the policy rate hikes announced in May 2022, the interest rates for the underlying loans as well as the yield for the investor is expected to increase

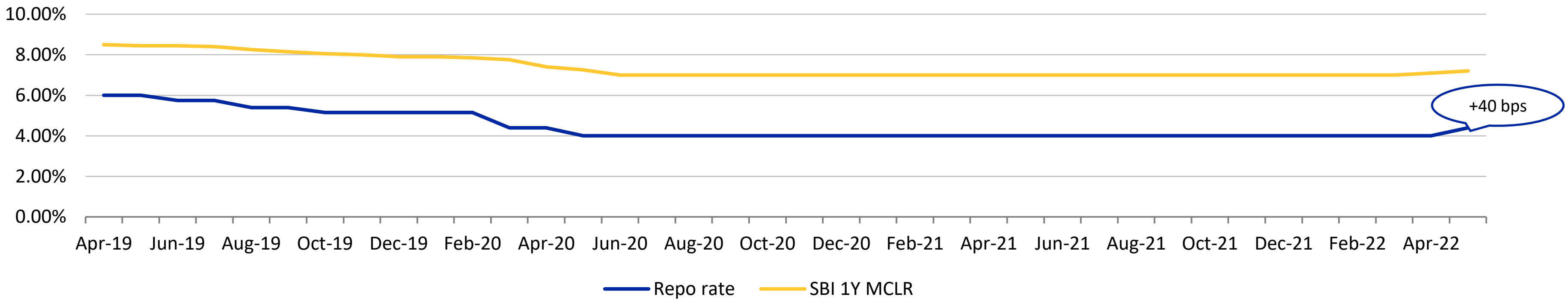
However, increase in interest rates is expected to have a limited impact on credit quality of ICRA-rated pools

This is due to presence of sizeable credit enhancement in MBS pools

- After a pause in 12 bi-monthly policy meetings, repo rate was raised in May 2022 to the level that prevailed in Q1 FY2021. Further rate hikes are expected going forward. Lenders are expected to step up MCLR / base rate, in line with the increase in repo rate, albeit the transmission may not be commensurate, given the competitive pressures.
- MBS transactions are inherently exposed to fluctuations in interest rates given the typical floating nature of mortgage loans.
- Though most of ICRA-rated pools (~80%) have floating rates on both pool as well as investor sides, the difference in benchmark rates – i.e. for underlying contracts & pass-through certificates (PTCs) - as well as timing of rate reset exposes the transactions to interest rate risks.
- In an increasing interest rate environment, lenders are expected to step up the marginal cost of fund-based lending rate (MCLR) / base rate / prime lending rate (PLR); however, the transmission may not be uniform, which in-turn could result in shrinking of extra interest spread (EIS) available in such MBS transactions.
- Despite the expected contraction of EIS, credit profile of MBS pool is not expected to materially weaken, given strong collections, availability of other forms of credit enhancements and possible pass-on of rate hikes with some lag to the underlying borrowers.
- ICRA-rated MBS pools continue to display healthy performance with no transaction witnessing a rating downgrade even during the stressed periods of the pandemic. Credit enhancement utilisation in most transactions has been low as the shortfalls in collections have largely been absorbed by the EIS.

Interest rates on the uptick after remaining stable over past two years

Exhibit: Repo rate and 1Y SBI MCLR

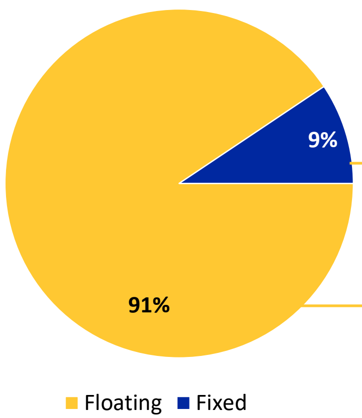


Source: ICRA Research, RBI, SBI

- After a pause in 12 Bi-Monthly policy meetings, the repo rate was raised in May 2022 to the level that prevailed in Apr-May 2020 (prior to Covid-related policy measures).
- ICRA expects MPC to raise the repo rate by another 40 bps in June 2022 and 35 bps each in the Aug 2022 and Sep 2022 reviews, followed by a pause to assess the robustness of growth.
- The marginal cost of lending rate (MCLR) has been increased by several banks in the wake of the rising interest rate scenario. Notable examples include SBI (20 bps increase over April & May), HDFC Bank (25 bps increase) and Axis Bank (35 bps).
- Going forward, lenders are expected to step up MCLR / base rate, in line with increase in repo rate, albeit the transmission may not be commensurate, given the competitive pressures.

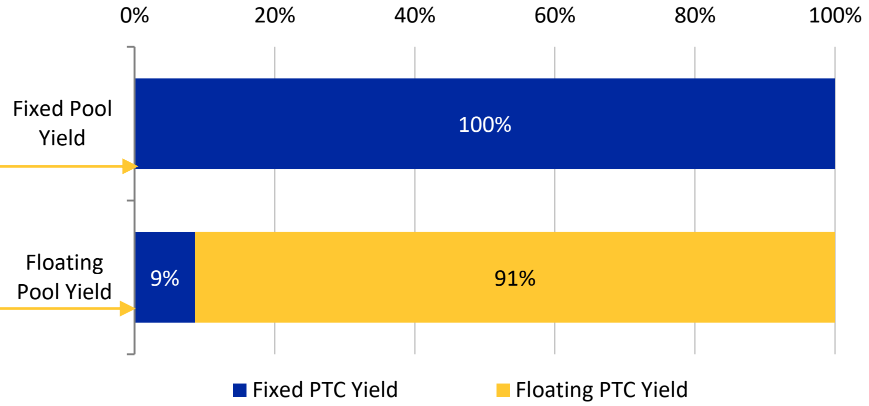
High share of floating rate MBS pools in ICRA-rated portfolio

Exhibit: Pool yield type for ICRA-rated MBS pools



Source: ICRA Research

Exhibit: PTC Yield Type based on Pool Yield of ICRA-rated MBS Pools

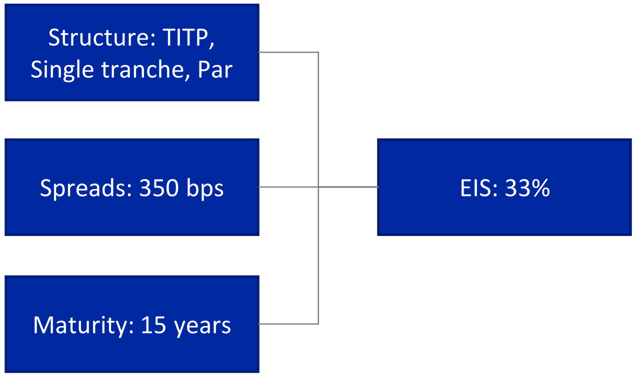


Source: ICRA Research

- MBS transactions are inherently exposed to fluctuations in interest rate given the typical floating nature of mortgage loans
  - 91% of ICRA-rated MBS pools comprise underlying contracts bearing a floating interest rate (linked to an external benchmark)
  - 83% of ICRA-rated MBS pools have a floating yield for the investors (i.e PTC yield)
  - 91% of ICRA-rated MBS pool with floating pool side yields also have floating PTC yield
- Even though most pools have both legs floating, the difference in benchmark rates (for underlying contracts & PTCs) as well as timing of rate reset exposes the transactions to interest rate risks

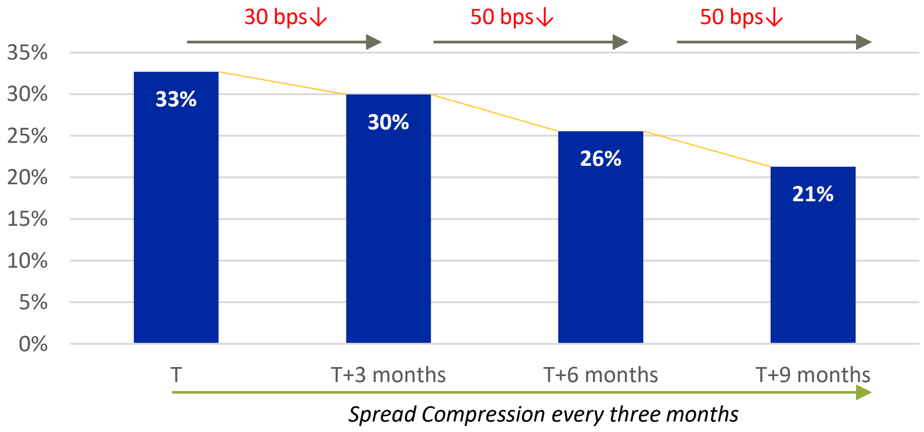
EIS expected to reduce with increase in rates; credit enhancement to remain adequate

Exhibit: EIS in base case scenario



Source: ICRA Research

Exhibit: Variation in EIS in with compression in spreads



Source: ICRA Research

- Credit enhancement available to MBS pools includes availability of extra interest spreads (EIS) and cash collateral. Principal subordination (through overcollateral or junior tranche), if available, provides further credit enhancement.
- EIS for a transaction with spread of 350 basis points and maturity of 15 years is estimated at 33% of initial pool outstanding. EIS would contract by 300 bps factoring in a 30 bps reduction in spread following the recent rate hike. Nonetheless, the credit profile of MBS pools is not expected to materially weaken given strong collections and availability of other forms of credit enhancements (cash collateral and principal subordination if any).
- Furthermore, the presence of floating rate contracts in underlying pools would help in reducing the spread compression to some extent as we expect the HFCs to eventually pass on a portion of the rate hikes to the borrowers through revision in their internal PLR, albeit with a lag of some months. Considering that interest rate transmissions across the different benchmarks may not be equal and / or simultaneous, the interim impact might be higher.

Risks associated with MBS transactions

ICRA

Interest Rate Risks: MBS transactions are exposed to interest risk fluctuations given the floating nature of underlying contracts (linked to a certain benchmark like MCLR, repo rate or other external benchmarks) and investor yield. Considering that interest rate transmissions across the different benchmarks may not be equitable and simultaneous, MBS transactions are exposed to basis risk

Maturity Profile: MBS pools have a long maturity profile given the nature of the asset class (average PTC term for HL pool is around 20-25 years and LAP pool is around 10-15 years) which could result in higher uncertainty associated with such transactions.

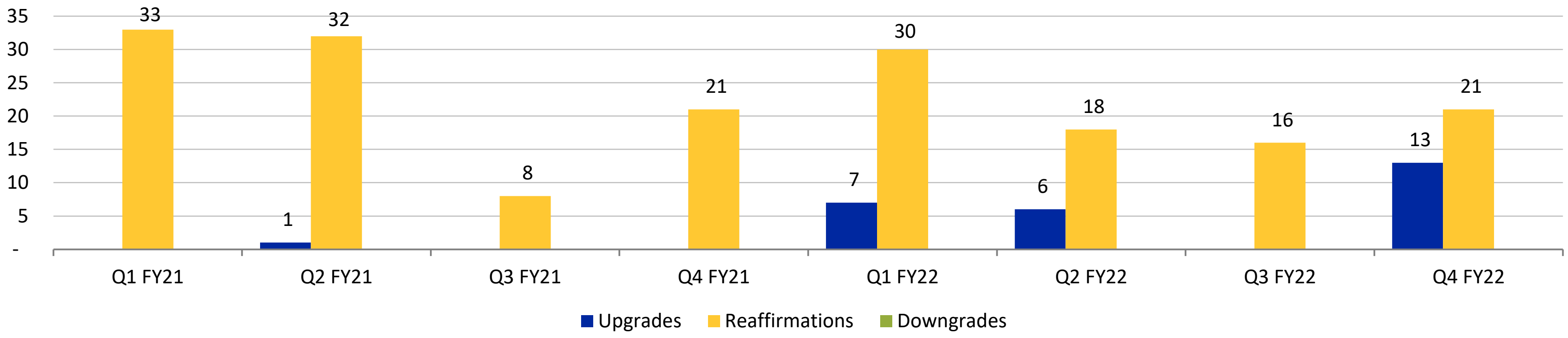
Prepayment Risks: Due to inherent longer tenure, there is a high risk involved due to prepayments and most pools mature before their expected maturity date

Credit Risks: Deterioration in financial / credit profile of underlying borrowers resulting in reduced ability to meet their financial obligations; inability to liquidate assets in a timely manner and recover outstanding amount in entirety could result in loss from the individual contracts

However, these risks are largely mitigated due to the strong repayment track record seen of borrowers towards home loans coupled with adequate credit enhancements in higher rated pools such that only a small proportion of pools witness cash collateral utilisation under stressed conditions

ICRA's rating actions on MBS instruments, post Covid

Exhibit: ICRA's rating actions (tranche-wise) for the period



Source: ICRA Research

- ICRA-rated MBS pools continued to display healthy performance, even in stressed periods of the pandemic, with no rating downgrades in the pools for the said period. Credit enhancement utilisation in most transactions has been low as the EIS was more than adequate to absorb the shortfalls in collections.
- Rating upgrades have been on account of build-up of credit enhancement on account of steady to high collections witnessed in MBS pools.
- In MBS pools, historically it is observed HL pools have comparatively superior performance than LAP pools as large proportion of the loans are secured by self occupied properties and hence default rates tend to be low.

Click to Provide Feedback

Analytical Contact Details

	Abhishek Dafria	Samriddhi Chowdhary	Sohil Mehta
	Vice-President & Group Head	*Vice-President & Co-Group Head*	*Senior Analyst*
Email	abhishek.dafria@icraindia.com	samriddhi.chowdhary@icraindia.com	sohil.mehta@icraindia.com
Phone	022 - 6114 3440	022 - 6114 3462	022 - 6114 3449

Business Development/Media Contact Details

L. Shivakumar	**Jayanta Chatterjee**	**Naznin Prodhani**
Executive Vice-President	*Executive Vice-President*	*Head Media & Communications*
shivakumar@icraindia.com	jayantac@icraindia.com	communications@icraindia.com
022- 6114 3406	080 – 4332 6401	0124 – 4545 860

ICRA

ICRA

Thank You!