

Press Release

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Defaults due to legal interpretation a threat to securitisation market*Such incidents, despite robust collections and cash collateral, can reduce investor appetite*

Recent defaults on some securitised instruments, triggered by a particular interpretation of recent Bombay High Court orders by an originator, pose a significant risk to the securitisation market and can materially reduce investor appetite if not addressed immediately.

The instruments were backed by loans originated and serviced by Dewan Housing Finance Corporation Limited.

The defaults were not because the transactions had run into cash flow problems. The collection performance of their underlying assets was robust and there was also substantial cash collateral to service the investor payouts comfortably.

The defaults had two triggers: one, the servicer of the securitised pools of receivables (also the originator) not transferring the collections to the Collection and Payout Account (CPA) based on its interpretation of the high court orders; and, two, the inability of trustees to access the cash collateral (typically fixed deposits [FDs]) in a timely manner to pay investors on the due date.

The Bombay High Court orders, prima facie, do not explicitly restrict the originator from depositing collections from securitised assets into the CPA from which investor payouts are made. The court has imposed restrictions on payments to secured and unsecured creditors. The originator has seemingly interpreted this to include servicing of securitised transactions.

The interpretation calls into question the bases on which ratings on securitised instruments differ from the credit profiles of originators – ‘bankruptcy-remoteness’ of securitised assets arising from ‘true sale’, and ‘bankruptcy-remoteness’ of ‘assets held in trust’ from the originator / servicer. These derisking features are the bedrock of securitisation transactions not just in India, but worldwide.

Bankruptcy-remoteness ensures that neither the originator nor the servicer owns the assets – they only manage them as counterparties to a securitisation transaction. Consequently, the assets would not form a part of the liquidation estate of the originator or the servicer (*see Annexure 1*).

This endows a superior credit quality, which is the primary reason why securitisation volume has surged in the past one year. In the 12 months ended September 2019, volume nearly doubled to Rs 2.3 lakh crore from Rs 1.2 lakh crore, offering much-needed liquidity to non-banks struggling to raise monies through vanilla debt instruments.

Says Krishnan Sitaraman, Senior Director, CRISIL Ratings, “If there is no immediate clarity on the legal standing of securitisation transactions in relation to the liquidation estate of originators / servicers, the ability of credit rating agencies to differentiate the credit quality of securitised instruments from their servicers and originators will be affected. That can significantly impact investor appetite for securitisation transactions, and potentially limit access to funding for non-banks through this route. It can also affect the government’s recently announced partial credit guarantee scheme under which securitisation of Rs 1 lakh crore of assets is to be facilitated.”

Equally worrying is the non-adherence to transaction terms by some counterparties in these transactions (*see Annexure 2*). There appear to be instances where banks that held FDs as cash collateral for the safety of investors have, in contravention of transaction covenants, insisted on consent from the collateral provider (typically the originator of a securitisation transaction). That impaired the ability of the trustees to access the FDs to pay investors. In another instance, trustees apparently didn’t have access to documentation related to FDs, which led to default.

Says Rohit Inamdar, Senior Director, CRISIL Ratings, “Maintaining the structural integrity of securitisation transactions by all counterparties is quintessential to the credit quality of securitised instruments. In the long term, the securitisation market would benefit from a legislative framework for securitisation that provides legislative sanctity to all key aspects of such structured transactions.”

Annexure 1

Key reasons for the rating of securitised instruments being different from that of the originator

The credit rating of a securitised instrument is driven by the credit quality of the securitised assets and the quantum of credit enhancement available in the structure to withstand shortfall in collections because of risks like credit risk, co-mingling risk and/or market risks. The rating can be different from the credit quality of the originator.

Credit ratings on securitisation transactions in India are typically higher than the credit profiles of the originator because of the 'true sale' and 'bankruptcy-remoteness' of underlying receivables and the cash collateral. These transactions generally have layers of safety embedded, comprising internal credit enhancements (such as over-collateralisation and / or excess interest spread) and external credit enhancements (such as cash collateral and / or third-party guarantees).

CRISIL's approach towards differentiation of ratings has been supported by opinion provided by independent legal counsels on CRISIL-rated securitisation transactions, as per the Reserve Bank of India's Securitisation Guidelines, opining on the following:

1. 'True sale' of the assets from the originator to a special purpose vehicle as set out in the Reserve Bank of India's Securitisation Guidelines or Partial Credit Guarantee Scheme Offered by Government of India to public sector banks
2. 'Bankruptcy-remoteness' of securitised assets from the originator, explicitly stating that in the event of bankruptcy, liquidation or winding up proceedings being taken against the originator (seller), under Indian law, the securitised assets would not be regarded as the assets of the originator, i.e., creditors of the originator would not be entitled to proceed against receivables in case of winding up of the originator
3. 'Bankruptcy-remoteness' of the cash collateral (CC), stating that the CC is available for the benefit of the investors and would be 'held in trust' by the CC provider and will not be treated as assets of the CC provider even in the event of any liquidation or insolvency of the CC provider

CRISIL also reviews executed legal documents and auditor certificates stating that the securitised assets are unencumbered as part of its ratings on securitisation transactions.

Annexure 2

Key counterparties typically seen in Indian securitisation transactions

Originator: Original lender of the loans securitised and seller of the receivables; has no role to play after sale of assets unless it takes over any of the below-mentioned roles.

Cash collateral provider: Provides cash collateral that serves as a credit enhancement for the transaction, and holds it in trust for the benefit of the investors. Typically, the originator is the cash collateral provider.

Servicer: Collects periodic instalments from the underlying borrowers, furnishes information regarding pool performance to the trustee and rating agency and deposits the collection amount into the Collection and Payout Account for the benefit of the investors. Typically, the originator performs the role of the servicer.

Trustee: Representative of the investor; whose responsibility is to ensure that the transaction is executed as per the terms, make investor payouts, access cash collateral as required for making payouts and hold investor meetings to take critical decisions.

Cash collateral bank: Bank with which cash collateral is placed as fixed deposit (with lien marked to the trustee, and to be operated by the trustee) for the benefit of the investors.

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