

Securitisation Market in India

The Securitisation market in India has grown considerably over the years along with the asset & mortgage finance market. The Securitisation issuance which includes Asset Backed Securities (ABS), Mortgage Backed Securities (MBS), Single Loan Sell Downs (SLSD) / Collateralized Loan Obligation (CLO) and Direct Assignment of loans is estimated to exceed Rs. 500 billion in F.Y. '07-'08. Unlike developed countries where MBS are more prevalent, it is the ABS papers which have been the main driver of Securitisation market in India contributing more than 50% of total issuance. The market for MBS papers has been comparatively subdued due to underdeveloped mortgage market and lack of investor's interest in long term papers. The major originators / issuers in Securitisation transactions are Private Sector Banks, Non Banking Finance Companies (NBFC) and Housing Finance Companies (HFC). The Public and Private Sector Banks, Mutual Funds, Insurance companies are some of the major investors in Securitisation transaction where the underlying asset are varied like Vehicle loans, Construction Equipment loans, Personal Loans, Working Capital loans, Mortgage loans, Corporate loans etc. In recent times there has been sudden spurt in SLSD / CLO transactions & Direct Assignment transactions owing to low cost & time and less regulatory requirements.

Reserve Bank of India (RBI) issued guidelines in February, 2006 to cover the Securitisation transactions with the intention to develop the Securitisation market. This Guideline defined the transactions which can be treated as Securitisation and also laid down how such transaction should be treated by

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parties involved. The introduction of regulatory framework and certain requirements of guideline like amortization of profits & capital requirements for credit enhancement, brought a temporary stagnancy in the market. The proposed implementation of BASEL II framework in India shall bring more clarity and depth in the Securitisation market. The introduction of SEBI Guidelines on listing of Securitised debt will bring transparency and liquidity in the market through development of secondary market which will further propel the growth of Securitisation market.

Rating a Securitization Transaction

Credit rating for a Securitisation transaction is different from a conventional rating exercise. In conventional ratings the question is - what is the rating for the given instrument. In securitization rating , given the basic transaction structure, the question is - what is the rating at a particular credit enhancement.

CARE's basic assessment in rating a securitization transaction, given a sound legal & transaction structure, is to determine whether the credit enhancement is sufficient to cover the deficits in pool cash flows even under stressed scenarios related to the target rating. These stressed scenarios relate to losses and delays in recovery from the underlying securitized pool which may lead to a loss or delay on the securitized instrument, if the credit enhancement is not sufficient. Therefore all the risks (credit risk, prepayments risk, etc) that affect the underlying pool get translated into credit risk for the rated securitized instrument and the rating assessment boils down to whether the credit enhancement is adequate to cover the credit risk on the securitized instruments even under the most extenuating circumstances.

CARE's analysis of a securitization transaction covers the following major areas:

- Strength of the Transaction Structure

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- Assessment of the underlying asset – pool receivables
- Cash Flow analysis of the transaction structure

Strength of the Transaction Structure

Transaction structure underlying a securitized instrument relates to the legal structure put in place for execution of the transaction and the way in which the cash flows between different parties will be exchanged. It can take a variety of forms but should adhere to certain basic principles. Typically a Special Purpose Vehicle (SPV) in the form of a trust is set up to whom the underlying receivables are assigned by the originator. The SPV then issues securities which entitle investors in these securities a right to the cash flows from the underlying receivables. The Servicer appointed for the transaction, generally the originator itself, performs the collection & monitoring function and transfers the periodic collections to the trustee / collection and payment agent. These periodic collections are then passed on to investors as per priority or Waterfall Mechanism defined for the transaction.

The legal documents should confirm to true sale criterion, whereby the sale of receivables along with security interest is complete and binding. The sale should be irrevocable and there should not be any recourse to the seller / originator except to the extent of Credit Enhancement, if any, provided by the seller / originator. The SPV should be bankruptcy remote implying that the bankruptcy of the seller / originator would not effect the interest of investors. The legal documents, executed to affect the transaction structure, comprise Deed of Assignment – to transfer the receivables as per terms and conditions of the transaction, Trust Deed – to create the SPV and define its constitution, Cash Collateral Agreement – for creation of Cash collateral / Credit enhancement for the transaction, Power of Attorney & other documents.

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CARE obtains an opinion from an independent legal counsel confirming the true sale criterion and appropriateness & adequacy of the legal documents as per governing laws and regulations.

Assessment of the Underlying Asset

- ***Originator Analysis***

Operational practices and abilities of the originator critically affect the quality of the loan pool which is to be securitized. CARE's basic analysis here is – how good is the originator in terms of underwriting the loans and following up for collections. CARE places a lot of emphasis on the strength of the originator as weak originators, when acting in the capacity of servicer, will increase the transaction risk.

- ***Portfolio Analysis***

CARE looks at the recent trends in asset quality of originator's total portfolio which provides indicators for the movement in the actual pool to be securitized. Comparison with peer groups provides insights into the possible reasons for a worsening or improvement in asset quality and its likely impact on the securitized pool.

- ***Static Pool Analysis***

Static pool is a set of loans originated during a particular period of time and no new loans are added to this pool. The actual pool to be securitized is also a static pool in this sense, i.e. once the loans in the pool are decided on the cut-off date, no new loans can be added to this pool in future. A static pool contrasts with a portfolio to which new loans are added and from which expired loans are removed regularly.

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Static pool analysis is an important part of CARE's rating process. Static pools are defined based on various characteristics of underlying security / asset. Performance history of the Static pools is used to estimate the past default, delinquency and prepayment rates and their distribution across pool tenures. This analysis is an useful input in determining the indicative base rates for pool with different underlying security / asset characteristics.

- ***Collateral (Actual Pool) Analysis***

Typically the collateral (actual pool to be securitized) is selected as per pool selection criteria which cherry picks an optimal pool. In collateral analysis CARE also looks at the diversification (granularity) and distribution of the pool. A well diversified pool (where diversity can be in terms of location, loan amount, etc.) is likely to have lower concentration risk and in turn a lower stressed loss expectation. Collateral's distribution in terms of loan size, tenure, IRR, loan maturity, etc. is assessed and compared with the trends derived from portfolio and static pool analysis.

- ***Economic Analysis***

CARE's economic analysis in a securitization transaction looks at the possible changes in the macro factors which may affect the receivables from the underlying pool. In case of securitization of loan receivables backed by underlying security (e.g. vehicles, construction equipment, etc.), CARE looks at the prevailing market scenario (valuation, demand, supply, secondary markets, and depreciation rate) for the underlying security. General economic factors which are likely to affect the income available with underlying obligors (borrowers whose loans are being securitized) and their repaying ability are also considered for projecting the pool behavior.

Cash Flow Analysis

- *Cash Inflows – Base Case & Stress Case*

CARE's assessment of the underlying loan asset pool forms the basis of projecting future receivables from the pool. CARE estimates the future cash receivables in a base case & a stress case scenario. In base case projections, the focus is on cash receivables in average conditions for defaults, delinquencies, prepayments, interest rates, asset valuation, etc. In stress case projections there is a simultaneous stress on all these variables which would lead to lower future receivables and the level of stress depends on the target rating. Therefore the stresses applied for a target rating of say CARE AAA(SO) would be substantially higher than for stresses applied for a target rating of CARE A(SO).

- *Scheduled Cash Outflows*

Transaction Features – Credit Enhancement, Par vs. Premium, PTC rate

CARE then projects the cash outflows based on the transaction structure, the interest rate to be paid to the investors and amount and maturity of the investment. Some of the important information of the transaction structure include the amount and type of credit enhancement, whether the structure is Par or Premium and interest rates & tenure of the various securities issued in this securitization. Some of the forms in which Credit Enhancement can be provided include cash collateral, subordination, overcollateralisation, excess interest spread, etc.

- *Final cash flow modeling to assign rating*

A cash flow model is then built to combine the projected cash inflows and outflows along with the credit enhancements. The waterfall mechanism (which defines the rules in which cash inflows get distributed) along with the payout settlement mechanism are also incorporated in the cash flow model for the

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transaction. The object of this Cash Flow Model is to combine all the features of the transaction structure and the underlying asset pool to arrive at a comprehensive position of the transaction. CARE assesses the sufficiency of estimated cash inflows (both in base case and stress case scenarios) together with credit enhancement to cover the promised cash outflows to the investor. The final rating is arrived at this point.

Primary Risks

○ *Default Risk*

Default risk of the underlying loans is the primary risk in securitization transaction as they result in a permanent reduction in cash flows available to pay to the investors. Credit enhancement is provided to cover this risk in the transaction.

○ *Delinquency Risk*

Temporary delays in payment from underlying loans may also result in deficiency in promised cash flows to the investors. Coverage for this risk is provided either as part of the credit enhancement or separately as a liquidity facility.

○ *Prepayment Risk*

The severity of prepayment risk depends on the transaction structure. If the securitization is a premium structure, then all the receivables (interest as well as principal) are securitized and par value of the security is higher than the principal outstanding on the underlying loans. High prepayments on loans with high IRR can lead to substantial reduction in future receivables and in turn lead to a cash flow deficiency. Therefore adequate credit enhancement in premium transactions should be provided after considering prepayment risk. In a par

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transaction, the credit given to excess interest spread as a source of credit enhancement is computed only after stressing for prepayment risk.

- *APR compression*

Average Percentage Rate (APR) is the weighted average interest rate paid by the underlying loan pool borrowers. The excess of APR over the interest rate payable to the securitization investors in a Par structure is what is called as excess interest spread (EIS). Generally in Par transactions the EIS is subordinated to the payouts to investors and is a source of credit enhancement to the transaction. However the strength of EIS as a credit enhancement gets weakened if the defaults or prepayments occur in loan cases which have high interest rates. This would lead to APR compression wherein overall pool APR gets reduced due to early termination of high interest rate contracts thereby reducing the strength of EIS as an enhancement. CARE stresses Par transactions for APR compression risk while assessing the overall strength of the transaction.

- *Commingling Risk*

The servicer (generally the originator) in a securitization transaction collects receivables from the underlying loan contracts (collateral) and passes these receivables as per the payout schedule to the investors. During this time lag between receivable collections and investor payouts, the servicer holds in custody the monies which actually belong to the investors. Commingling risk is the risk that these funds may get temporarily used by the servicer for its own operations. This risk gets accentuated in a structure with staggered cash flows. CARE looks at the short term credit rating of the servicer as a mitigant to commingling risk.

Rating Process

Rating process starts when originator contacts CARE for discussion of the proposal. Details of the proposal along with pool information are provided by the originator to CARE. CARE also requires data on originator's past portfolios and static pools. *Typical data requirements are presented in Annexure I.* Along with the quantitative assessment of the transaction, discussion with the management is done to understand management policy, operational capabilities and vision of the company. Once CARE's analyst complete the analysis, assessment note for the same is presented in CARE' Rating committee and committee decides the rating of the portfolio at given credit enhancement, which is then conveyed to the originator. Normally analysis for an originator who has approached CARE for the first time, will take slightly longer time than a transaction in which the originator already has a securitization transaction rated by CARE.

Surveillance

CARE reviews the rated transactions on a regular basis. Monthly performance reports which provide collection & payout details, information on overdue status, use of credit enhancement (if any) and other information of the transaction are reviewed by CARE. Purpose of the surveillance is to ensure that rating reflects the actual pool performance. If there is any major deviation found in the performance then CARE would take the necessary rating action.

Disclaimer

CARE's ratings are opinions on credit quality and are not recommendations to buy, sell or hold any security. CARE has based its ratings on information obtained from sources believed by it to be accurate and reliable. CARE does not, however, guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. Most issuers of securities rated by CARE have paid a credit rating fee, based on the amount and type of securities issued.

Annexure I – Data Requirements – Securitization Rating

<i>Frequency: Initial + Annual, Once for an originator.</i>	
Historical Loan-wise data	<ul style="list-style-type: none"> • Loan Characteristics – Type, LTV, Tenure, IRR, Location, Category, New/Old, Borrower profile. • Loan Performance <p>Billing & Collection</p> <p>Foreclosure, Prepayments, Recovery</p>
Originator’s Recent Portfolio Data	Ageing Analysis – asset class-wise <ul style="list-style-type: none"> • Gross NPA levels – asset class-wise
Qualitative Information (Meeting with the Management)	<ul style="list-style-type: none"> • Loan origination & appraisal systems • Advance / down-payment policies • Valuation of underlying assets • MIS systems
Past securitization transactions	<ul style="list-style-type: none"> • Performance Data
<i>Frequency: Transaction Wise</i>	
Actual Pool Data & Proposed Transaction Structure	