

CREDIT ALERT

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Securitisation: Central government's intervention and clarification need of the hour

A credit alert is CRISIL's opinion on a sharp and specific development. It conveys that CRISIL will revert shortly on the impact of the development on the ratings of those affected.

The past three months have seen a spate of downgrades and defaults on securitised instruments backed by receivables originated by Dewan Housing Finance Corporation Ltd (DHFL; the originator). CRISIL, too, has recently downgraded its ratings on pass-through certificates (PTCs) issued under DHFL-originated transactions (refer to the links for CRISIL's latest rating rationales on [Nirmaan RMBS Trust - Series II – 2014](#) and [Nirmaan RMBS Trust - Series V – 2014](#)).

The rating actions were triggered primarily by legal challenges that call into question the basic tenets of securitisation. These developments will need to be monitored closely and have the potential to impact the growth of India's developing securitisation market that has, in the recent months, been the life-line of non-banks. Any disruption in the securitisation market, in turn, has implications for the country's financial sector and the wider economy.

The situation calls for urgent intervention by the authorities concerned to contain the risks. A major action that has become an imperative is as follows:

- *A central government notification pertaining to Rule 10 (dealing with third-party assets) of Insolvency and Bankruptcy Rules (Insolvency and Liquidation Proceedings of Financial Service Providers and Application of Adjudicating Authority), 2019, clarifying that the securitised assets (including assets which are sold under direct assignment transactions) and the associated credit collateral are to be kept outside the bankruptcy proceedings and to be dealt with by the Administrator as set out under the executed documents of securitisation transactions and purely for the benefit of the PTC-holders*

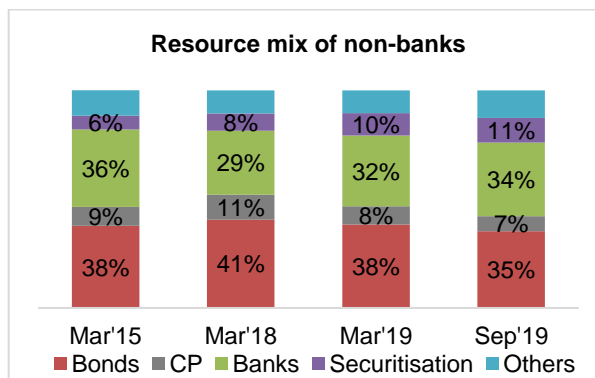
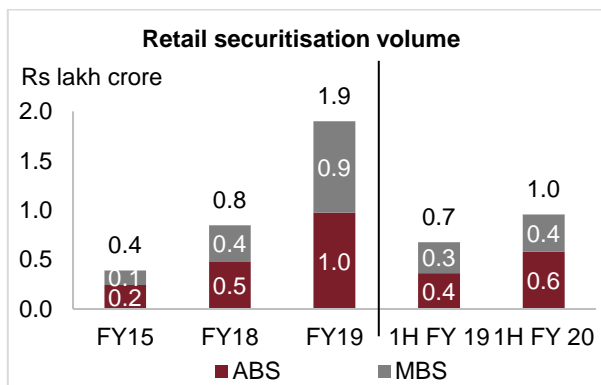
What will also support future growth of the securitisation market is a legislative framework for securitisation (including assets which are sold under direct assignment transactions) covering all key aspects of such structured transactions. This will go a long way in addressing challenges emanating from misinterpretation of legal orders.

Sanctity of 'bankruptcy-remoteness' is the bedrock of the securitisation market

The legal construct of securitisation transactions is intended to ensure that the securitised assets are legally sold to a special purpose vehicle (SPV) and a legal separation of the originator is effected from the assets. The 'bankruptcy-remoteness' of the assets, i.e. the legal separation by virtue of which the securitised assets do not form part of the liquidation estate of the originator/servicer in the event of bankruptcy, is a key de-risking feature of securitisation.

Accordingly, securitisation transactions are evaluated by market participants, based primarily on the credit quality of the securitised pool of receivables and the availability of credit enhancement in the structure, with limited or no linkage to the creditworthiness of the originator (which is typically the same as the servicer and the cash collateral provider). Bankruptcy-remote structures enable securitised instruments to enjoy ratings that are typically higher than the rating of the originators.

Investors, too, make the same differentiation. This is evidenced by their willingness to take up securitisation exposures even as they did not readily invest in vanilla debt issued by many non-banks (non-banking finance companies and housing finance companies) since September 2018. The zooming securitisation market volumes and the growing reliance of non-banks on securitisation as a fundraising avenue also bear testimony to this.



But basic tenets of securitisation are being repeatedly challenged by legal ambiguities

A few of the erstwhile frequent originators of mortgage-backed securities went into financial distress in the challenging operating environment post-September, 2018.

Despite the financial difficulties of the originators, with some of them defaulting on their financial obligations, the performance of the securitised pools of assets remained respectable across the board. For instance, the monthly collection ratio of DHFL-originated and serviced pool under CRISIL's surveillance has remained steadily above 99%. Consequently, payouts to PTC-holders were unimpeded despite defaults on the originator's/ servicer's on-balance sheet exposure, until the legal challenges started rearing their heads in October 2019 (see the table below for the sequence of events).

Sequence of events impacting securitisation deals

Oct 10, 2019	The Bombay High Court restricted DHFL from making payments to secured and unsecured creditors, except where payments are made on a <i>pro rata</i> basis to all secured creditors.
Payout status post the order	Despite the order being silent on payouts to securitisation transactions, DHFL stopped depositing collections on securitised assets into the collection and payout account (CPA) of the trusts based on legal counsel's interpretation of the order. This effectively denied PTC-holders access to the cash that was rightfully theirs, but held by DHFL for the benefit of the PTC-holders. Several transactions were affected, triggering sharp downgrades and defaults on ratings of securitised instruments.
Nov 13, 2019	The High Court granted ad-interim relief to investors in securitisation transactions by directing DHFL to make payments for present as well as future dues as per assignment agreements executed by it.
Payout status for November 2019 post the ad interim relief	Given the clear directions of the High Court regarding the present and future dues, DHFL resumed depositing collections into the trust accounts, which were utilised to make payments to the PTC-holders and to top-up cash collateral, where required.
Dec 3, 2019	Just as a semblance of normalcy was returning to the market, the Mumbai bench of the National Company Law Tribunal (NCLT) admitted the application filed by the Reserve Bank of India (RBI) to initiate insolvency proceedings against DHFL.
Payout status post the NCLT order	Despite the Insolvency and Bankruptcy Rules (Insolvency and Liquidation Proceedings of Financial Service Providers and Application of Adjudicating Authority), 2019 being clear that third-party assets held in trust are outside the scope of the liquidation estate and not subject to any moratorium in payments, DHFL has again stopped funding the CPAs citing that the central government notification relating to Rule 10 (pertaining to dealing third-party assets) is still awaited. The PTC-holders' access to cash collateral (which is typically held in trust by the originator / servicer) has also been hampered. Several transactions have been affected, with many instruments defaulting on the payments. The situation is unlikely to be resolved until the authorities issue notification related to Rule 10. Several more securitised instruments may default / be downgraded in the next few weeks if the relevant notification is not issued.

Impact of these developments on the securitisation market are concerning

The legal and regulatory developments raise questions on the very basis of delinking the ratings on securitised instruments from the credit profiles of their originators.

The ramifications are significant:

- The ability of credit rating agencies and investors to differentiate the credit quality of securitised instruments from their servicers and originators could be affected
- Widespread defaults driven by the apparent futility of structural features inbuilt in securitisation transactions could dent investor confidence, especially with savvy investor communities such as mutual funds, family wealth offices, private banks and foreign banks
- The partial credit guarantee scheme announced recently by the government, under which securitisation of Rs 1 lakh crore of assets is to be facilitated, might be impacted if banks develop cold feet on lack of clarity of the bankruptcy remoteness of securitised assets
- Given that non-banks (*excluding government owned non-banks*) accounted for 18% of the credit outstanding in the economy as of March 2019, and the quantum of funds raised by non-banks through securitisation in the past two years ended September 2019 was Rs 3.4 lakh crore, such an unexpected legal obstacle can create systemic risk for the economy

It is thus imperative that necessary steps are taken on a war-footing to address the issues threatening to significantly impact the growing securitisation market.

CRISIL will continue to monitor the developments on this and take appropriate action.

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