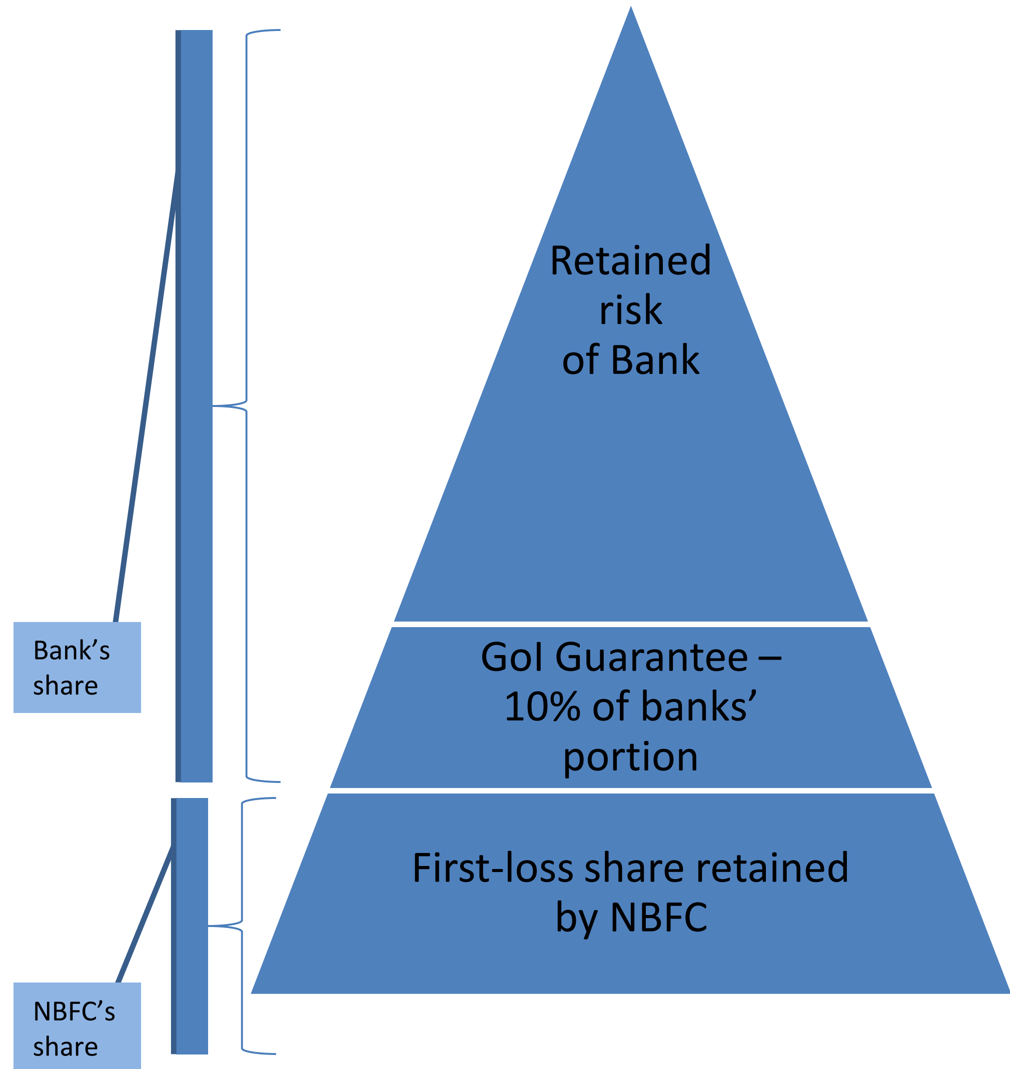
Partial Credit Guarantee Scheme

Vinod Kothari
Director, Vinod Kothari Consultants P Ltd
Director, Indian Securitisation Foundation

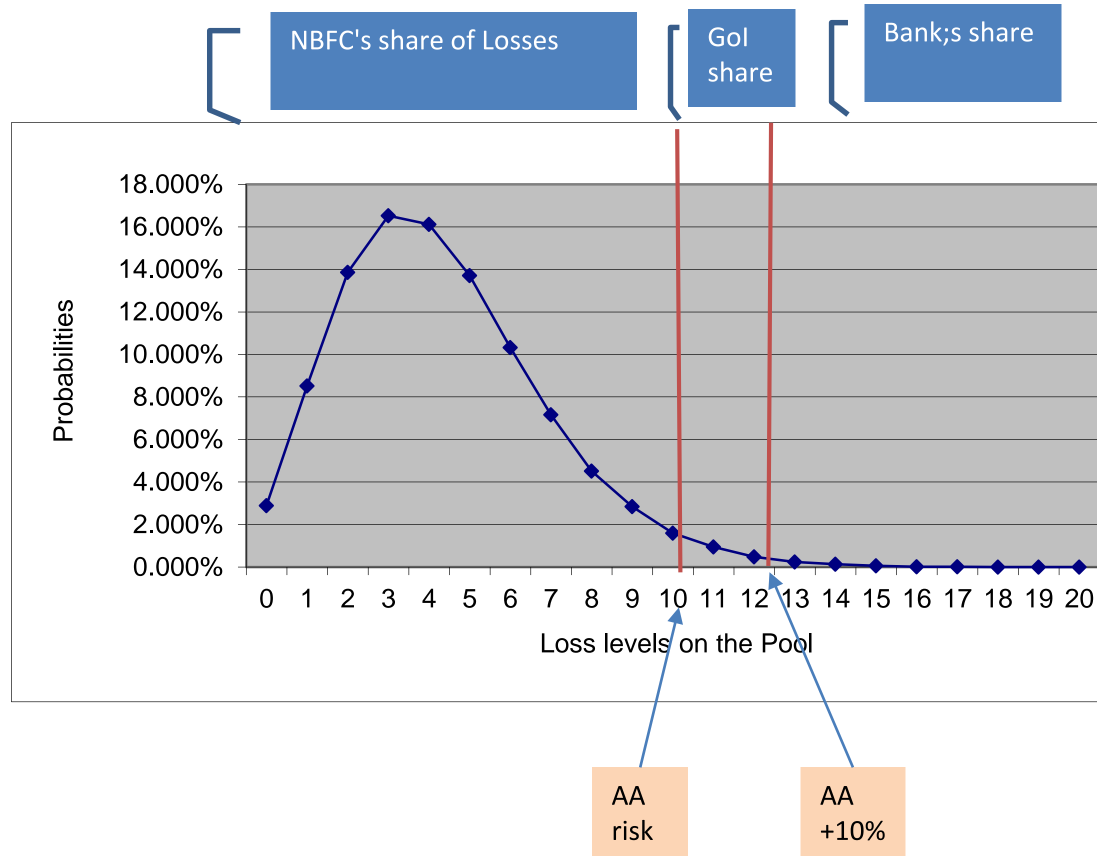
403-406, Shreyas Chambers
175, D N Road, Fort
Mumbai – 400 001
vinod@vinodkothari.com/ info@indiansecuritisation.com
www.vinodkothari.com;
www.indiansecuritisation.com

Basic Understanding

- What does the Scheme do?
  - Encourages PSBs to buy NBFC pools
  - Superimposes a 10% GoI guarantee on AA-rated pool of NBFC assets, purchased by PSBs
  - As it is practically impossible to think of AA assets in a pool, the AA-rating is possible only with internal or external credit enhancements
  - The GoI guarantee is referred to as First loss guarantee, but is actually a mezzanine support
- Minimum risk left with the bank
  - Upwards of risk at AA level +10% GoI guarantee
- Since the support of GoI is unfunded, maximum funding is transferred to PSB
  - Thereby creating liquidity with the NBFC



Loss distribution



Numerical example 1/2

- Assume an NBFC has originated a Pool
  - LAP loans
  - Average tenure of 120 months
  - POS of Rs 2000 crores
  - Weighted average IRR 12%
- A pool of Rs 500 crores is proposed to be transferred in accordance with the Scheme
  - Selection is done following selection criteria so as to minimise the credit enhancement required

- In order to take the pool to a AA level, NBFC provides a 7% credit enhancement
  - Different modes of enhancement possible
    - Internal
      - Subordination, over-collateralisation, cash collateral
      - Usual practice in India has been cash collateral, but cash collateral is inefficient as it results into negative carry
      - We would prefer subordination/over-collateralisation
    - External, that is, third party support
      - Funded, that is, a third party taking a slice of the first loss piece
      - Unfunded, that is, third party providing a synthetic support to the Pool
      - In case of unfunded support, the rating of the third party will become important – must be at least AA
    - Blended:
      - Combination of internal and external support

Numerical example 2/2

- Assuming we settle on a 7% subordination, NBFC transfers Rs 465 crores worth senior share in the Pool
  - Retaining Rs 35 crores subordinated share
  - NBFC may retain a subordinated excess spread over the agreed coupon rate of the PSB as well
- PSB agrees to buy Pool at par value of Rs 465 crores, and interest rate of 9%.
- GOI guarantee of 10% of bank's share, viz., Rs 465 crores
  - Guarantee commission payable @0.25% on Rs 465 rore
- Costs of the NBFC:
  - Coupon rate 9%
  - Guarantee commission 0.25%
  - Servicing fee (which is its own revenue
- Returns of the NBFC
  - Excess spread on Rs 465 crores
  - RoI on retained portion of Rs 35 cores
- Hence, the RoI on the NBFC's 7% share
  - 48.53% [12%+93%/7%*(12%-9%-0.25%)]
  - The multiplier effect will be more if the NBFC's retained share is lower
- A win-win deal for all
  - GOI gets 0.25% guarantee commission for a risk at AA level, however, for a term of only 2 years
    - Risks are essentially back heavy
  - Bank gets a 9% return with a sovereign exposure
  - NBFC gets a substantial leverage, otherwise not possible either in on-balance sheet funding or in securitisation

Unique features

- The Scheme is a hybrid between securitisation and direct assignment
  - It has to use credit enhancements to uplift the ratings to AA level; hence different from a direct assignment
  - It is not securitisation, as it does not involve SPVs or “securities”
- Therefore, it is a *sui-generis* transaction
- As such, it becomes an additional mode of NBFC-Banks’ alliance
  - Co-lending
  - Direct assignment
  - NBFC referenced, supported origination on banks’ books
  - Securitisation
  - **PCE scheme**
- The Scheme is unlikely to be used for PSL loans

Applicability

- Seller features
  - NBFC/HFC registered with RBI/NHB, excluding MFIs and CICs
  - CRAR not below minimum
  - Must have made profits in last 2 years
  - NNPAs must not be above 6%
  - Must not have been under SMA category by any bank prior to 1st August 2019 (typo in Press Release says 2018)
- Buyer features
  - Must be a PSB, as only PSBs are eligible for govt guarantee under GFR
- Guarantee features
  - Upto 2 years, or till the PSB holds the Pool, w/e is earlier
  - On a first loss basis, 10% of fair value paid
- Asset features
  - Originated upto 31st March 2019
  - Standard as on date
  - Pool to have AA rating prior to partial guarantee
  - Each loan fully disbursed and security charge created
    - Does not seem to mean that the loans must be secured loans
  - Homogenous assets in pool, with size of an asset ≤ Rs 5 cr
  - Ineligible assets as in case of DA – revolvers, purchased loans, loans with bullet
- Transaction features
  - Purchase by PSB at fair value
  - May have a buyback option, on right of refusal basis
    - Does not seem like a free-standing option

The Guarantee and how it works

- Guarantee fee
  - 0.25% p.a. on the fair value of loans purchased by PSB
  - Presumably, as the guarantee is renewed on 1st April next, it will on the fair value of the outstanding POS
- Loss determination should be pool level, and not individual loan:
  - Manner of intrinsic support from excess spread
- GoI is guaranteeing the PSB
  - Therefore, the loss in the Pool must first hit the PSB
  - That is, the CE support at seller level must have been exhausted
- The assignment documentation will need to define how are losses to be recognised
  - Once the loan becomes 90 DPD
  - Delinquent instalments, or the whole loan?

True sale and Bankruptcy Remoteness: Relevance

- The assignment must satisfy the usual conditions of bankruptcy remoteness
  - Must result into a true sale
- RBI FAQ of 30th August seems to be intended for regulatory capital relief, and not for legal true sale.
- Bankruptcy remoteness is common law issue – will have to be dealt with time-tested true sale principles
- Will be critical to provide buyer protection against risk of insolvency of seller
- The following by themselves do not kill true sale:
  - Retention of excess spread, in a properly devised manner
  - Retention of servicing rights/service fees
  - Retention of subordinated/pari-passu share
  - Provision of credit enhancements not amounting to economic recourse
- However, the following are normally fatal to true sale:
  - Retention of right of buyback, or a buyback agreement, indicating a loan-type repurchase arrangemenet
  - Buyer accounting for all surplus
  - Buyer eligible to recover all losses

Accounting and regulatory capital relief

- Capital relief
  - First loss support provided by originator to require capital fully
  - Second loss support provided by a third party to be 100% risk-weighted; or risk-weighted based on rating
  - NBFC to get capital relief to the extent of pool sold to PSB
- Buyer's risk weight should reflect AAA risk weights, since there is 10% guarantee over AA rating
- Accounting for the cost of guarantee
  - NBFC is bearing the cost of guarantee
  - Should be amortised over the term of guarantee
- Off balance sheet treatment
  - IndAS 109 conditions:
    - Transaction may not qualify for component transfer conditions, unless IO strip retained by originator for excess spread is a fully proportional strip
  - Originator retains risk upto AA-rating, transfers risks beyond
  - Retains excess spread, which may be subordinated
  - If there was no risk transfer to the PSB, there was no question of a GoI guarantee to support the buyer's risk
    - Hence, there is a strong argument for applying partial risk transfer/continuing involvement approach
  - If off balance sheet, there will be gain-on sale as well

Transfer at fair value

- Lot of confusion prevailing about prescription for fair value purchase
  - Fair valuation is quite a common feature in IndAS accounting
  - Also, in any arms' length transaction, there is pre-requisite of fair value
- Fair value of what?
  - Fair value of the portion/PO +IO tranche being acquired by buyer
- Fair value at what discounting rate?
  - Presumably, the coupon rate agreed between parties with the GoI guarantee reflects the risk of the cashflows
- Hence, if excess spread over the agreed coupon rate is retained by originator as credit enhancement, the fair value will be equal to POS acquired by buyer

Economics of the transaction

- Seller provides for credit enhancement at AA
  - Therefore, exposes regulatory and economic capital at AA level
  - Buyer buys with AA+10% sovereign guarantee
  - The thickness of risk for a diversified retail pool between AA and AAA rating level is rarely 10%
  - Therefore, buyer gets super-senior asset
- Hence, if the spread differential between AA and super-senior risk acquired by buyer is adequate to absorb cost of guarantee, the transaction makes sense for the seller
- Asset classes for which transaction will make sense:
  - Longer than 2 years weighted maturity
    - LAP loans, vehicle loans, corporate loans, MSME loans
- What sort of originators will scheme make sense:
  - Spread differential is the key
  - Lower-rated originators will arguably find the scheme better
- Risks of the Buyer:
  - Illiquidity after 2 years; the remaining tail may be risky and illiquid
  - Can the coupon rate have a step-up feature?
    - E.g., 9% for 2 years, 12% thereafter?
  - Adverse selection risk
    - Loans which have not been packaged in securitisation/DA transactions may be bundled under the Scheme
  - Servicer risk – we have never tested servicer migration
  - True sale challenges under bankruptcy law