Article

Reset of Credit Enhancements Guidelines for securitisation transactions

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RBI has recently released the Guidelines on Reset of Credit Enhancements in Securitisation Transactions[1] which has left element of ambiguity contrary to what the intent of the regulators was when the revised securitisation guidelines were released in 2012.

Reset of credit enhancement has had a mention several times in the past, in the draft guidelines for securitisation transactions issued in September, 2011 wherein bank proposed to permit reset of credit enhancement subject to certain conditions. Later when the final revised guidelines for securitisation transactions was issued by RBI in May, 2012, RBI expressed that the reset guidelines would be issued separately. The Monetary Policy Statement for the year 2013-14 indicated that the RBI would come out with the guidelines by end of June, 2013 and the reset guidelines were duly issued on 1st July, 2013. In this article, we will be discussing the reset guidelines in detail and also elucidate the ambiguity it has brought about with respect to maintenance of credit enhancement and MRR in the transaction.

Understanding credit enhancements and reset

Before we discuss about reset of credit enhancements and discuss the guidelines threadbare, it is pertinent to understand what credit enhancements are. Credit enhancements are devices put in the securitisation transaction to mitigate the risk of default in the pool of assets, provide cushions to the senior securities for them to attain higher rating, to enhance the security or the credit of the securitised instrument.

With regard to maintenance of skin in the game and retaining risk in the transaction by way of MRR, the securitisation guidelines of 2012 explain that

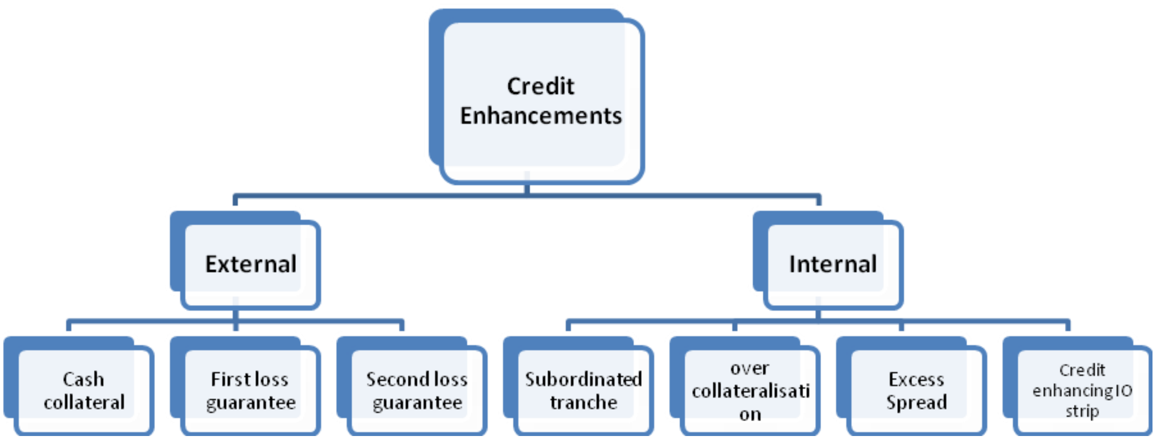
> ***The MRR as a percentage of unamortised principal should be maintained on an ongoing basis except for reduction of retained exposure due to proportionate repayment or through the absorption of losses***. *The form of MRR should not change during the life of transaction.*

This means that MRR needs to be maintained as a part of **unamortised principal** in the transaction and NOT on the initial pool value. MRR is only a **fixed** percentage of the unamortised principal and not the initial pool value.

[1] The guidelines on Reset of Credit Enhancement in Securitisation were discussed in the monetary policy of 2013-14 on May 3, 2013. Thereafter RBI's revised Guidelines on Securitisation Transactions issued on 7th May, 2013 mentioned that separate guidelines with regard to reset will be issued by RBI, end of June, 2013. On 1st July, 2013, RBI released the guidelines on reset of credit enhancement and can be viewed here http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=8149&Mode=0#ann

Highlights of the Reset Guideline

The guideline first, distinguishes credit enhancements as external and internal credit enhancements and allows reset only in case of ***external credit enhancements*** subject to fulfilment of certain conditions. The two broad categories of credit enhancements include:

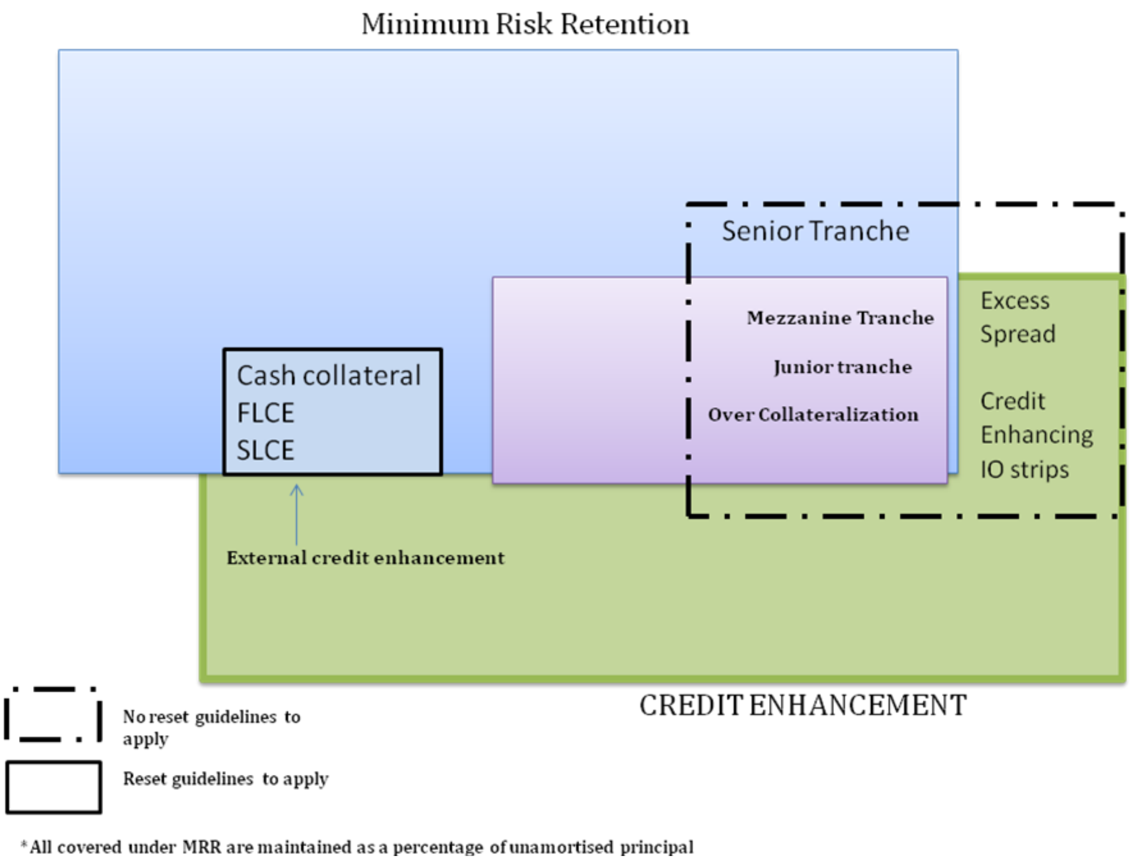


The types of credit enhancements listed in the two categories indicate that internal credit enhancement means such credit enhancements available to the transaction from the cashflows itself whereas external credit enhancements may mean enhancement modes provided over and above the cashflows of the asset.

While a vertical tranche held by the originator may also be considered for MRR purposes apart from junior and mezzanine tranche, credit enhancement is a cushion to the senior securities to mitigate the risk of default, the senior tranche will not qualify as credit enhancement. With regard to MRR, there is no reset requirement it needs to be maintained as a fixed percentage of the unamortised principal as explained above. Hence there is no question of reset guidelines being applicable to the junior, mezzanine or senior piece held by the originator for the purposes of MRR.

With regard to credit enhancements as the reset guidelines mention, that reset is not allowed in case of internal credit enhancements which may include the junior, mezzanine tranche held by the originator as these anyway are maintained as a fixed percentage of the unamortised principal. Reset guidelines are applicable only in case of external credit enhancements.

This is explained by the graph below:



This means that reset is natural in case of internal credit enhancements, in case of external credit enhancements, reset guidelines of RBI shall apply.

Conditions for reset:

The original amount of external credit enhancements provided at the time of initiation of securitisation transaction can be reset subject to the conditions as enumerated below:

1. At the time of reset, re-rating of the outstanding tranches of securities, other than equity tranche which is not rated**.** Reset will not be allowed in case any of the ratings of the tranches has deteriorated from the original rating so provided. Subsequent resets would not be permitted if the rating of any of the tranches has deteriorated vis-à-vis the rating at the time of previous reset.
2. Reset would be subject to consent of trustees.
3. The quantum of credit enhancement required for retaining original or current outstanding rating (whichever is higher rating) shall be determined by the rating agency that initially rated the transaction, at the time of reset.

4. The reset of credit enhancement should be provided for in the contractual terms of the transaction and the initial rating of the transaction should take into account the likelihood of resets. Where transactions have been carried out since 7th May, 2013, terms of reset can be inserted with the consent of the investors of outstanding securities.
5. Reset may be carried out simultaneously between first loss credit enhancement (FLCE) and second loss credit enhancement (SLCE) in a proportion such that the reset maintains the outstanding rating. ***However, reset of equity tranche is not allowed as it would tantamount to internal credit enhancement.***

Further conditions on reset:

1. The pool of underlying loans must demonstrate satisfactory performance before reset is permitted. The terms and conditions/triggers to be complied with are as below:
    a. At the time of first reset, at least 50% of the total principal amount assigned at the time of initiation of the securitization transaction must have been amortised. The subsequent resets may be carried out after the Pool principal has amortised up to at least 60%, 70% and 80% of the original level. However, a minimum gap of six months and one year should be maintained between successive resets for transactions of up to 5 years' tenor and more than 5 years' tenor, respectively.
    b. Excess credit enhancement released are subject to the below conditions
        i. A reserve floor of atleast 30% of initial credit enhancement is to be maintained;
        ii. A maximum of 60% of the credit enhancement in excess of that required to retain the credit rating of the all the tranches can be considered for release;
        iii. The reset should not lead to exposures retained by the originator along with credit enhancements offered by them falling below the level of MRR prescribed.
    c. No reset should happen if the 'Delinquency Trigger' is breached.

Formulae for delinquency trigger to be breached:

Delinquency trigger = All overdues upto 180/365 days + Total Value at Risk (overdues + Future Principal outstanding) in deeper buckets + Other losses(irrespective whether written off or not) > 50% of amortisation adjusted amount of FLCE+SLCE

AND

All overdues upto 180/365 days + Total Value at Risk (overdues + Future Principal outstanding) in deeper buckets + Other losses not written off > 50% of amortisation adjusted amount of FLCE+SLCE

FLCE: First Loss Credit Enhancement
SLCE: Second Loss Credit Enhancement

All conditions to reset:

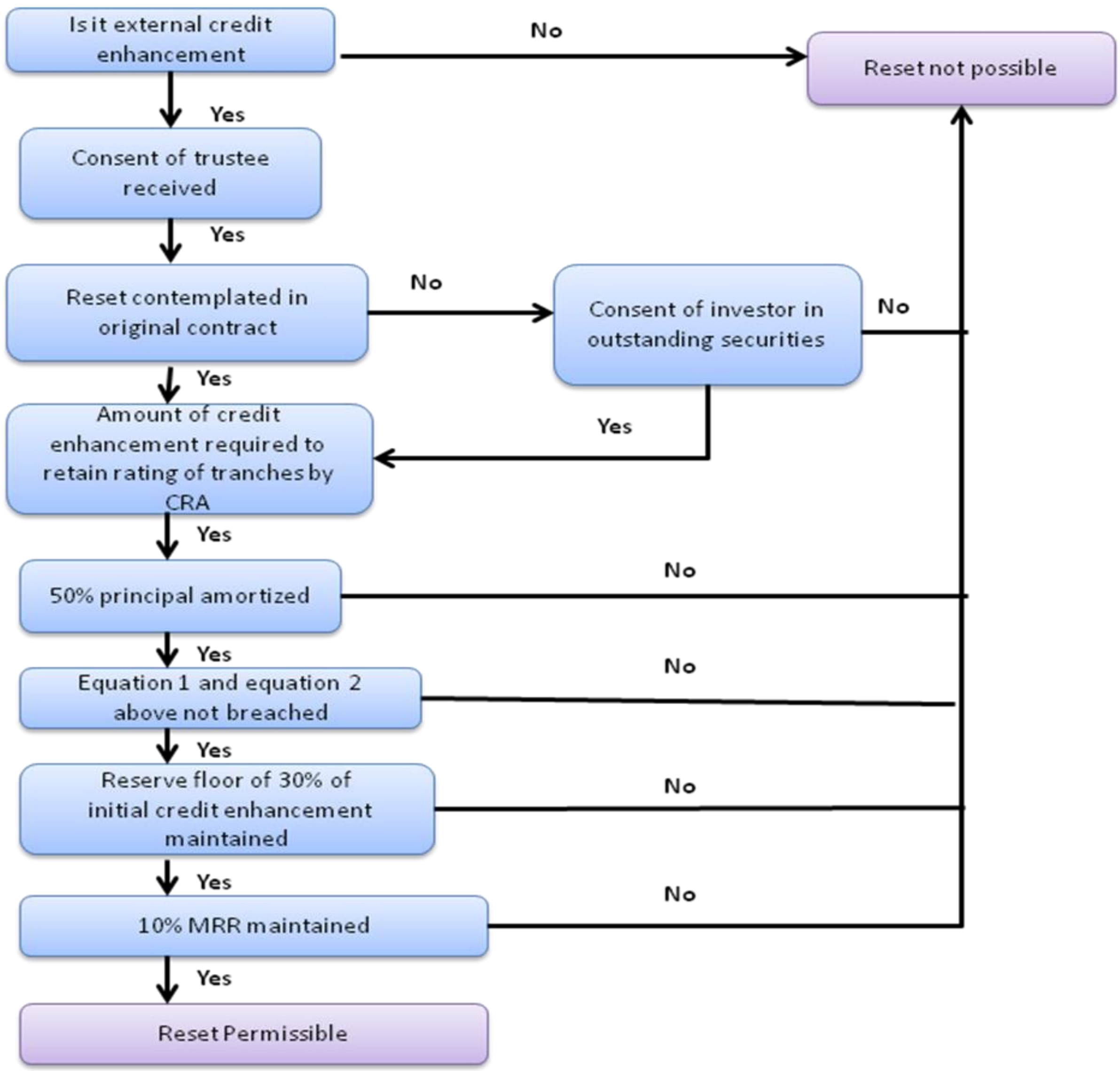


Illustration from RBI

The guideline also lays down illustration for reset in an appendix[2] to the guideline, which we will discuss in detail herein below.

The summary of the illustration[3] of RBI is as below:

1	Initial pool value	1000
2	Credit Enhancement (FLCE + SLCE)	150 + 50 (200)
3	Pool value outstanding	420
4	Credit Enhancement before reset	150

[2] http://rbidocs.rbi.org.in/rdocs/content/pdfs/RCE01072013_A.pdf
[3] http://rbidocs.rbi.org.in/rdocs/content/pdfs/RCE01072013_A.pdf

5	Credit Enhancement after reset	120
6	% of CE initially	20% (200/1000)
7	% of CE before Reset	35.71% (150/420)
8	% of CE after Reset	28.57% (120/420)

The illustration provided in the reset guideline has several confusions mentioned below:

1. While for a pool of receivables worth Rs. 1000, the credit enhancement required was 20%, as the pool runs down, the credit enhancement requirement has increased. Even after reset it is higher than the initial credit enhancement required. This reflects that for a larger pool of receivables the transaction will maintain certain credit enhancement, but as the pool may run down for a smaller pool a larger credit enhancement shall be required. The understanding is counter-intuitive.
2. The first loss credit enhancement (FLCE) and second loss credit enhancement (SLCE) have been shown as “**Reserves**” in the transaction balance sheet which is unclear.
3. As per the securitisation guidelines of 2012, MRR may also include a vertical tranche of securitised paper in addition to equity or subordinate tranche to ensure that the originator has stake in the performance of securitised assets for the entire life of the securitisation process. In the illustration, for MRR purposes, FLCE is considered but SLCE is not considered, even though SLCE is partly provided by the originator as well (See pt. 5 of the illustration).
4. The securitisation guidelines of 2012 mention that MRR of the unamortised principal is to be maintained on an ongoing basis except for reduction of retained exposure due to proportionate repayment or through the absorption of losses. In 21. 4, (c) MRR is required is shown as 42, this would mean that the total MRR to be maintained would be 42 irrespective of being a vertical or subordinate tranche or FLCE or SLCE. **Here RBI is making it clear that the MRR requirement is 10% of the unamortised principal in the transaction, which is what the intent of the securitisation guidelines of 2012 state as well.**

   Below we illustrate the essence of RBI’s intent in the securitisation guidelines of 2012 on maintaining MRR as a percentage of unamortised principal and how the economics of the transaction would become unviable if the credit enhancements are maintained as a percentage of the initial pool value even when the pool is drawing down.

CE illustration with capital relief.xlsx

As is evident from the illustration, even after reset guidelines are to apply, with the amortisation of the pool, the MRR requirement keeps increasing over the tenure of the transaction. As the MRR increases, the weighted average cost to the originator increases. Which may make the transaction unviable, unless reset is done on an ongoing basis after 50% of the amortisation condition is met. Further the capital relief available to the transaction also is significant, which make the transaction unviable once significant amortisation of the receivables has happened. To give a peek into the cost impact, the 34th month the pool outstanding is Rs. 100 approx whereas the capital required is Rs. 35. Surely the intent of the regulators may not have been such when the 2012 securitisation guidelines were issued.

5. In 21.j. the total investment by the originator eligible for MRR considers the senior tranche and FLCE. SLCE has been omitted here again.

The illustration leaves one confused about the intent of the regulators on the MRR, CE requirements and what is to be achieved with the reset guidelines. Surely while it may seem that the market has moved from a worst position to a worse of position with these reset guidelines, but the bottomline is that the intent of the regulators was not to have either scenario existing in the first place. It is time regulators removed the shade of ambiguity and directed the market appropriately.