Raising funding by Securitisation in the new scenario 2012

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Highlights

- Separate guidelines for securitisation and direct assignments
  - Internationally, regulators lay down single criteria for transfer of financial assets – whether to SPVs or to another real life entity
- Resolve most the issues created by the 2006 Guidelines
- Unduly harsh on direct assignments, but quite flexible and at par with international rules on securitisations
  - No, originators do not necessarily have to retain 10% risk
- Recognition of profits:
  - Amortisation rule not in line with accounting standards
- Direct assignments:
  - Difficulties may be avoided by structuring a loan as a transferable instrument, or a bond

So what is securitisation?

- Guidelines do not define "securitisation"
  - Descriptive features are given such as "Securitisation involves pooling of homogeneous assets and the subsequent sale of the cash flows from these asset pools to investors".
  - Marketplace meaning of securitisation to be taken:
    - transfer of receivables to SPVs
    - SPVs issuing securities which are liquidated from out of the cashflows
    - Supported by credit enhancements, but primarily, repayments come from the transferred cashflows
  - Reference to SPVs not there in the definition of securitisation; however Guidelines refer frequently to securities of SPV
- Borderline of distinction between "securitisation" and "direct assignment" may be thin:
  - It is not necessary for SPVs to issue pass through certificates
  - If the originator transfers assets, and SPV issues bonds, it may seem like a direct assignment
  - Likewise, if a single investor buys all the securities of the SPV, it is no different from a direct assignment
  - In the language of the Guidelines, the only difference seems to be "securitisation", that is, existence of securitised paper
- Essential difference between securitisation and direct assignment is – whether the assignee is a real life operating entity, or a special purpose entity solely deriving its cashflows from the transferred assets

What all can be securitised

- Only performing assets
  - Transfers of non-performing assets are covered by separate guidelines
- Homogenous pool:
  - The oft-repeated references to homogenous pool in the Guidelines cannot be stretched beyond a point
    - Every homogenous pool is heterogeneous – it contains assets which are diversified
    - The meaning of homogenous is only same type of collateral :
      - For example car loans, home loans, corporate loans.
      - Homogenous meaning loans sharing similar risk characteristics from viewpoint of internal classification by the bank
- Assets that cannot be securitised:
  - Single loans
  - Revolving credit facilities:
    - Note there is no bar on revolving structure of securitisation
  - Purchased assets
  - ABS/ MBS
  - Loans with bullet payment of principal and interest

Revolving credit facilities

- What are revolving credit facilities:
  - Typically a line of credit where the customer is allowed to draw upto a limit
  - Can pay at any time
  - Once paid back, the limit is restored
  - Examples – cash credit, credit cards

Purchased assets

- The bar on purchased assets seems difficult to understand
- It would have been understandable if there was a MHP requirement here as well
- But a straight bar on purchased assets is not reasonable
  - For example, a bank may have bought the entire portfolio long time back,
  - may have even added its own funding
  - A bank may have bought different loans from different sellers, and may now want to resell the pool
    - The risk characteristics of the individual assets and the pool may be very different
- The prohibition becomes retroactive:
  - Assets bought prior to the new Guidelines cannot be securitsed post the Guidelines

Securitisation exposures: ABS/MBS

- Banks are also not expected to securitise their investments in ABS/ MBS
- Coupled with restriction on securitisation of purchased assets, whether purchased whole loans, or fractional interests, or ABS/MBS cannot be securitised
- However, no bar on:
  - Securitisation of participation rights, or syndicated loans
  - Loans acquired on purchase of entire portfolio of a bank exiting business

Loans with bullet payment terms

- Loans will bullet payments cannot be securitised:
  - Guidelines say, both interest and principal payable on maturity
  - General meaning of a bullet loan is principal payable on maturity
    - Interest may be serviced regularly
- Idea is understandable
  - In absence of any principal/interest payments during the MHP, there is no demonstration of the quality of the loan
    - Hence, seller has not taken any risk at all
- The prohibition burdened with lots of exceptions:
  - Agricultural loans of upto 24 months maturity
    - Provided the borrower has paid, within 90 days of due date,
      - past 2 loans of maturity upto 1 years
      - Past 1 loan with maturity of more than 1 year
  - Trade receivables of tenure upto 12 months, discounted or purchased by banks
    - Provided the obligor/drawee has paid last 2 receivables within 90 days of due date

Who can be the transferee?

- The Guidelines do not lay down who the transferee can be.
- As regards securitisation
  - Implicit understanding is that it is the SPV
- As regards direct transfers
  - No restriction apparently
  - Hence, banks or others may be transferees
  - Of course, the part of the Guidelines laying down requirements for the investor/buyer will apply only if the buyer from the financial system

Minimum holding period

- MHP runs:
  - From the date of full disbursement or purchase of the asset (in case of asset-backed loans)
  - To the date of transfer
- Since MHP requirements in the Table is number of instalments, the instalments payable before full disbursement or purchase of the asset are to be ignored
- Note MHP applies to the loan in question and not the borrower
  - For example, borrower has repaid the existing loan, and granted a new loan – can the new loan be sold?
    - No
  - Difficult question – however, if borrower took original loan, and before maturity, an add-on loan was given, can the whole loan be securitised:
    - Answer should be, Yes.
- MHP applies to all loans and not the pool
  - That is, assets not complying with the MHP to be filtered out
- MHP does not apply to agri loans and trade receivables of bullet maturity
  - Where track record of performance is seen with reference to previous payments
  - However, it is obviously important that the borrower must have had past track record with the originator

MHP matrix

	Minimum number of instalments to be paid before securitisation			
	Repayment frequency – Weekly	**Repayment frequency – Fortnightly**	**Repayment frequency – Monthly**	**Repayment frequency – Quarterly**
Loans with original maturity up to 2 years	Twelve	Six	Three	Two
Loans with original maturity of more than 2 years and up to 5 years	Eighteen	Nine	Six	Three
Loans with original maturity of more than 5 years	-	-	Twelve	Four

Risk retention requirements

- The discussion on risk retention has been the theme of regulatory reaction to the subprime crisis
- The risk retention requirements were imposed by EU regulators long time back in form of article 122a of CRD directive.
  - The terms horizontal slice, vertical slice and T slice came from there.
- EU regulations provide for 4 forms of risk retention:
  - Vertical slice
  - First loss piece
  - Originator risk retention in case of revolving transactions
  - Retention of randomly selected loans, where the pool consists of at least 100 obligors
- The extent of risk retention in both US and European regulations is 5%

MRR requirements under RBI Guidelines

- The essence of the Guidelines is to impose following MRR requirements (required MRR or RMRR):
  - 5% for transactions with original maturity of 24 months or less
  - 10% for transactions with original maturity exceeding 24 months
- Both of these are classed into 4 categories:
  - No tranching, no first loss credit enhancement
  - No tranching but first loss credit enhancement
  - Tranching but no first loss credit enhancement
  - both tranching and first loss credit enhancement
- Conceptually, the Guidelines have not properly appreciated distinction between first loss credit enhancement and tranching
  - For example, if there are Senior and Junior securities, the retention of junior securities by the originator is nothing but first loss support
- However, the Guidelines have taken first loss credit enhancement to refer to off balance sheet support (e.g., guarantee), over collateralisation and cash collateral.

So, quick understanding of the MRR

- No tranching, no first loss credit enhancement: RMRR % of securities
- No tranching but first loss credit enhancement:
  - the whole of the first loss support,
  - if first loss support < RMRR, (RMRR-first loss)% of securities
- Tranching but no first loss credit enhancement:
  - RMRR% of the value of securitised pool in the equity tranche
  - If equity tranche < RMRR, (RMRR-equity tranche)% of securities
- both tranching and first loss credit enhancement
  - Total exposure of the originator in first loss support + equity tranche to be RMRR
  - If less, the balance in senior securities

What counts are MRR

- MRR should be based on percent of the principal value
  - Investment in IO strip not be counted
- Several questions:
  - What if pool sold at more than par value:
    - Will MRR be based on outstanding pool value:
      - ☐ Clearly, Guidelines provide for RMRR% of securities of the SPV
      - ☐ Issue price Securities need not be the same as par value of pool sold
  - What if the securities of the SPV themselves are issued at a premium/discount:
    - International regulations lay a clear "economic recourse" rule
    - No such intent explicit in the Guidelines
    - However, the very purpose of risk retention is exposure of originator to losses upto RMRR % of the pool
    - Hence, the focus should be on the losses

Do the Guidelines mandatorily expose the originator to first losses upto RMRR%?

- Answer is, no.
- Principles are:
  - A first loss support must necessarily come from the originator
  - Likewise, equity tranche at least upto RMRR% must be held by the originator
- But the transaction need not provide for RMRR%
  - In that case, the originator invests in a vertical tranche.
  - So, in essence, what Guidelines lay down is a combination of horizontal + vertical tranche – the so-called L tranche

So, what is first loss piece?

- In the language of the Guidelines, it seems other than the equity tranche (that is, the junior-most security, other than IO strip), all forms of originator support are treated as first loss support
- However, if there are 2 or more levels of support, then the first loss piece is only the junior piece.
- Guidelines leave lot of flexibility permitting originators to minimise first loss retention
  - Unlike EU regulations or even the regulations under Frank Dodd

Maximum retained risk

- The Guidelines blame it on Basel II to impose a limit to the extent of originator's retention of ABS/MBS
  - Basel II concept is founded on "substance over form"
    - That is, if there is no in-substance transfer of risk, then there is no capital relief
- There is, however, a basic difference between Basel II and the Guidelines:
  - Basel II is a capital standard, not regulation.
- The maximum exposure of the bank should not exceed 20% of issued securities, including
  - Credit enhancements, whether funded or funded + equity tranche
  - Any investments in senior tranches
  - Any liquidity support
- The excess will be straight deduction from capital
  - Guidelines provide for 1111% risk weight
- This is surely very different from Basle II requirements
  - Under Basel II, if there is no substantive risk transfer, the transaction does not qualify for capital relief
  - Not qualifying for capital relief is not the same as capital deduction.
- Guidelines clarify that if amortisation of the pool results into increase of originator interest, the Guidelines will not be deemed breached
  - Same will arguably apply to repayment of senior tranches too

Does the MRR remain constant through the term?

- One of the big confusions in the Feb 2006 Guidelines was that the first loss support had to remain constant through the term of the transaction
- The Guidelines (# 1.3.4) make it very clear that amortisation of the RMRR is possible
- In other words, RMRR has to remain constant as percentage, not as amount
  - Payback of RMRR, not faster than the payback of the senior classes, is therefore possible

Recognition of gain on sale

- Off balance sheet treatment and gain on sale recognition are accounting issues
  - In principle, it is not proper for a regulator to lay accounting rules
  - Particularly when they materially differ from accounting standards
- Accounting standards relate off balance sheet and gain on sale together – latter being the consequence of the former
  - If there is a sale, there is a gain/loss on sale
  - Gain/loss is the logical consequence of a sale treatment
    - How does one justify the recognition of gain/loss being deferred if the sale has been recognised already

RBI rule on profit recognition creates illogical scenarios

- Only cash profit can be recognised
  - What is cash profit?
    - Where the sale price of the pool exceeds its par value
- The expression "cash profit" is very difficult to understand
  - Guidelines require the originator to invest RMRR% of the securities of the SPV
  - To the extent of originator's contribution to such securities, there is no "cash profit"
  - However, it would be illogical to limit cash profit to only consideration paid by third parties
- This leads to two extreme scenarios, both leading to absurd results:
  - If "cash profit" means only third party consideration, then given the RMRR requirements, most securitisation transactions would lead to a cash loss
  - If cash profit includes consideration paid by the originator too, then every originator will have a free hand in increasing equity tranche and *generating* a cash profit
- Eventually, the accounting rule must be allowed to prevail:
  - The fair value of the retained interest of the originator is allowed to be booked upfront
  - Fair value takes into account estimated losses.

Amortisation of profit

- Guidelines distinguish between two types of profit:
  - Realised profit – so-called cash profit
  - Unrealised profit
    - Guidelines make a reference to IO strip:
      - Most Indian transactions have not had anything called IO strips
        - However, residual profits have flowed back to originators on sweep-all-left basis
    - IO strip is certainly not the only for unrealised gains
- In case of realised profits, Guidelines require amortisation of the profits by spreading the profits:
  - Spread based on higher of:
    - Proportionate splitting, in proportion to principal amortised
    - Equal splitting, in proportion to number of months
- The formula given in Guidelines puts a number L (mark to market loss) within the brackets with a Max formula
  - Loss is a negative number:
    - The max formula will always ignore the loss
- In case of unrealised profits, Guidelines have envisaged only IO strip
  - Hence, provide for profit to be recognised only when actually received

So what, if I don't follow the Guidelines

- Para 1.8 sets out the impact of non compliance
- In line with Basel II requirements, the Guidelines have only been set as a capital standard
  - It is not a mandatory regulation
- That is, banks may securitise outside the Guidelines too
  - There will no capital relief in such cases
- However, para 2.1.1 kills the impact of para 1.8
  - Investing banks shall not invest in securitised tranches unless originating bank has complied with MHP and MRR requirements
    - This is in line with EU regulations
- However, the non-regulatory stand of the Guidelines is still an appreciable difference from the previous Guidelines

Direct assignments

- Commentators have criticised the Guidelines as it virtually kills the direct assignment business
- No doubt, the provisions of the Guidelines about direct assignment are inconsistent
- But no one should really lament the adverse impact on direct assignment business
  - Direct assignments are not something that was the first love of the market
  - The market shifted to direct assignments following the Feb 2006 guidelines
- So, if we are forced to move back to "securitisation" structure, that is a forward move, not backward
  - However, the Guidelines have been unduly harsh on direct assignments, as simpler bilateral sales don't have to follow the complex structure of "securitisations".

What is eligible and what is not

- Ineligible assets are the same as in case of securitisation
  - Revolving credits
  - Purchased loans
  - Bullet repayment loans
- Guidelines do not apply to the following:
  - Transfers that happen with the request of the borrower
    - This would mean novation transactions will also be excluded
  - Inter-bank participants
    - Arguably, also the transferable participation rights envisaged by Nair committee
  - Trading in bonds:
    - Guidelines will promote issue of bonds as a replacement of loans, particularly in case of corporate lending
      - Bonds become an easy route to escape the entire Guidelines
  - Sale of entire portfolio upon exit decision
    - Entire portfolio
      - Once again, should mean a portfolio sharing risk features
        - For example, portfolio in a particular region may be seen as a portfolio
  - Consortium or syndication arrangements in case of CDR
  - Specific exemptions

So, how to banks ensure liquidity of their loans

- The whole loan sale market is quite a liquid market internationally, particularly the so-called leveraged loans market
- Many such loans are written to be sold
- CDS is not allowed in case of loans – ruling out synthetic transfers
- So, how do banks ensure that their loans are liquid
  - Transforming a loan into a transferable instrument
    - Bonds are transferable, and are outside the purview
- Downside
  - Bonds require MTM valuation
    - Under IFRS 7, even loans require MTM valuation
    - MTM does not necessarily mean volatility of reported profits
      - In case of AFS assets, the gains/losses on MTM are parked in "other comprehensive income"

MHP and MRR

- MHP is the same in case of securitisation
- However, MRR becomes curious
  - The Guidelines require retention of 10% cashflows
    - This would mean a fractional transfer
      - Fractional transfers under common law systems lead to joint ownership
- Given the other prescription – no credit enhancement, it would imply the retained risk is a pari passu risk
  - Meaning, the seller sells 90% of the loan, retaining 10% of the loan, on a proportional basis
    - Does this meet the requirement of retention of risk?
      - The originator only has 10% of the risk, not risk *upto* 10%
- Guidelines also say, seller should not hold back IO strip
- In essence, the direct assignment business is fully "hands off" sale
- Legal validity of the proportional transfer
  - Is fractional transfer valid?
    - Unquestionably so, just that the seller and buyer become co-owners

Profit recognition in case of direct assignments

- The profit recognition rule is the same as in case of securitisations
- This is, however, most illogical
  - Since the originator is not exposed to any credit risk of the transferred pool in case of direct assignments, the question of the seller not recognising a profit does not arise at all
  - Selling holds only a pari passu interest
    - So, if the seller transfers 90% of the pool, there is no reason for the seller not to recognise 90% of the profit, whether realised or unrealised

Nagging questions..

Does securitisation mean no capital relief?

- Several analysts apprehend, there is no capital relief now
  - Why? Because Guidelines require RMRR
  - To the extent of RMRR, there is a deduction from capital
- This is, however, is a misconception
- Guidelines do not require first loss equal to RMRR
  - Guidelines provide, to the extent of first loss, the originator must hold it
  - Remaining RMRR may be by way of vertical tranche
  - Hence, H piece + V piece may be equal to the RMRR
  - In essence, the requirement of the Guidelines is an L piece
- To the extent of H piece only, capital of the originator suffers

Will direct assignments dry out?

- Not exactly
- Direct assignment over securitisation
  - Direct assignments are easy to execute; securitisation structures are complex
  - Direct assignments do not involve tax unclarity; securitisation does
  - Direct assignments give full capital relief; securitisation does not
- Securitisation over direct assignment:
  - Tranching, time tranching, interesting combinations of credit and prepayment risk
  - Securitisation will be cheaper; direct assignment will costlier

So, this is how the market may evolve

- Capital-starved originators may still prefer direct assignment; price sensitive originators may work out securitisation
- Securitisation structures may work out variety of H and V tranches:
  - Lower the H tranche, higher the capital relief, but higher the cost of the transaction
  - Hence, depending on the cost objectives, originators may work out combinations of H and V tranches

Third party credit enhancements

- In direct assignments, can a third party provide credit enhancement?
  - Surely yes
- There is a distinct opportunity for third party credit enhancers, particularly for direct assignments
- The way the model may work:
  - Transaction may be credit enhanced upto BBB level by first loss support
    - In case of securitisation, originator takes the first loss; in case of direct assignment, both the originator and investor take it pari passu
  - From the BBB level to AAA level, a third party enhancer may provide support
- Impact on the transaction economics:
  - Cost to the originator comes down
  - Capital relief increases