
Risk Alerts issued by ICRA keep investors and lenders informed about ICRA's views on key developments or trends taking shape in specific sectors or in the broader economy that may have implications from a credit perspective

Background

This 'risk alert' addresses the concerns arising out of the sharp deterioration in the credit profile of some of the servicers in the rated securitisation transactions. Following the multi-notch downgrades in the ratings for a few entities in the recent past, even the pass-through certificates (PTCs) issued under the securitisation transactions originated by these entities have seen significant rating downgrades (referred to as 'impacted transactions' in this note).

It may be noted that in domestic securitisation transactions, the originator continues to act as the servicer/ collection agent for the securitised loan contracts and there is no concept of an upfront identified back-up servicer. Therefore, there is material dependence on the servicer despite the pool receivables being 'bankruptcy remote' from the originator, post assignment to the securitisation trust. A significant deterioration in the credit profile of the servicer could impact its operations, and thus its servicing ability. This, in turn, could affect the collection performance of the underlying pools. Also, there is a commingling of pool collections with the other funds of the servicer. If the servicer's profile weakens, there is a risk that the servicer may not deposit the funds collected from the underlying borrowers in the trust account and may instead divert the funds for meeting its other obligations.

The role of other counterparties in the transactions, like the trustee and the bank with which the cash collateral is placed (or the guarantor, in case a portion of the credit enhancement is available in the form of a guarantee), is also important in securitisation transactions, and more so in impacted transactions. It is vital that all counterparties fulfil their obligations and adhere to the timelines/payment mechanism defined in the transaction documents to ensure that the payments to the PTC investors continue to be made in a timely manner.

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Role of the servicer

The servicer is the most important counterparty in any securitisation transaction. Unlike some other geographies, in Indian securitisation transactions, the originator continues to act as the servicer/collection agent for the securitised loan contracts and there is no upfront identified back-up servicer. While the transaction documents allow the trustee to replace the servicer, this has not been tested in the domestic market.

In case the original servicer defaults on its servicing obligation or is deemed to be unfit for the role, the trustee (usually acting on the instructions of the majority investors) can choose to step in and appoint an alternate servicer. The timely implementation of the same may prove to be crucial for the future performance of such transactions.

It is important to highlight that the servicer is only acting in the capacity of a collection agent in respect of the securitisation transactions and has no right or claims on the amount collected against the securitised contracts. While the commingling of funds is permitted for operational convenience, it is important that the servicer tracks the collections against the securitised contracts separately and earmarks the same for meeting the scheduled PTC payouts on the due date (and not for meeting its other obligations/expenses). Usually, the transaction terms stipulate that the funds be transferred to the trust account at a greater frequency than originally envisaged (to reduce the commingling risk) if the servicer's credit rating falls below a certain threshold. While the frequent transfer of funds is operationally cumbersome and may involve some negative carry, it is doable in ICRA's view. However, it has been observed that the servicer in the impacted transactions continues to transfer the funds at the originally specified frequency despite the breach of this trigger.

Similarly, the payment mechanism laid out in the transaction documents should be strictly followed. Typically, the transaction terms require the servicer to fund the trust account at least a day prior to the PTC payout date and the trustee to dip into the credit enhancement if the same does not happen. This is to ensure that the payouts to the PTC investors can be met on the due date even if the credit enhancement needs to be utilised. ICRA has observed that some entities do not fund the trust account in advance and deposit the funds in the relevant account only on the scheduled investor payout date (possibly to reduce the negative carry). The trustees also allow this to happen by not dipping into the credit enhancement (in case the advance funding does not materialise). This exposes the structure to a risk - the utilisation of the credit enhancement may not occur in a timely manner if the servicer defaults on its funding obligation. In other words, the payment to the PTC investors could be delayed despite the availability of credit enhancement. This risk is further heightened in impacted transactions with weak servicer profiles.

Servicer replacement

As mentioned earlier in the note, servicer replacement is an untested event in the domestic securitisation market. Therefore, the impact of the same on the pool performance of various asset classes remains to be seen. Due to this, the

servicer's credit rating (or ICRA's rating view on the servicer if the servicer is not rated by ICRA) is an important input for the assignment of a rating by ICRA to asset-backed security (ABS) and residential mortgage-backed security (RMBS) issuances. As per ICRA's criteria for the rating of securitisation transactions, the initial rating of any securitised paper is usually restricted to four or five notches above the servicer's own rating (or rating view).

As per ICRA, while the change in the servicer may be operationally cumbersome (especially due to the non-availability of any ready replacement servicer being identified upfront), it can certainly be implemented if required. The new servicer should preferably be an entity with a strong credit profile and a presence in most locations from where the pool contracts have been sourced. Alternatively, multiple collection agents can be appointed for different locations. In ICRA's view, the change in the servicer may entail the following steps:

1. The custody of all loan documents pertaining to the underlying pool contracts would need to be handed over to the new servicer.
2. The security interest (for secured loans) transfer to the trustee may need to be perfected. The cost implications for the same would need to be evaluated, especially when there is a need to liquidate any security. Also, the availability of recovery options like benefit of security enforcement under the SARFAESI Act with the new servicer is important from a credit perspective.
3. The underlying obligors would need to be notified about the transfer of the loan receivables to the trust and the appointment of a new servicer as a collection agent. Accordingly, the revised ECS/NACH mandates would need to be in favour of the new servicer.
4. In case the pool has variable loan rates, the interest rate may need to be linked to an external benchmark or the PLR/MCLR of the new servicer. Again, the underlying obligors would need to be notified accordingly.
5. The loan would need to move to the system/MIS of the new servicer. This is to keep a record of the performance of the loans and ensure that the service requests from the obligors, like statement of accounts, interest certificates, etc, for the loan, can be fulfilled by the new servicer.

If the alternate servicer charges a fee that is higher than what is stipulated in the transaction documents (and this additional fee is not met separately by the investor), it would result in lower availability of surplus cashflows for meeting investor payouts (as the servicer fee is typically senior to the investor payouts in the cashflow waterfall stipulated in the transaction documents). Therefore, the ability of the trustee to find an alternate servicer at an attractive fee would also be an important credit consideration. Full co-operation from the originator/existing servicer is paramount for ensuring the smooth transition of the servicer role to a new entity.

What could be done to alleviate counterparty risks?

The domestic securitisation market has seen exponential growth in the past few years with volumes soaring to ~ Rs. 2.0 lakh crore in FY2019. For the market to scale further, it would be important for investors to develop confidence that they are indeed investing in a pool of assets that are 'bankruptcy remote' from the originator, and that the investment is largely immune to any significant counterparty risk (especially the risk of servicer bankruptcy/default). ICRA believes that the same can be achieved to a large extent through the following measures:

- Identify and appoint a back-up servicer at the transaction initiation – This would mitigate the risk of the original servicer going bankrupt or failing to perform its role effectively. It would also ensure that the transition process for a change in the servicer, if required, is smooth. All the borrower/loan details can be shared with the back-up servicer upfront. Similarly, both the servicers can take joint custody of all borrower/collateral specific documents.
- Conservatively budget for upfront servicer fee in the transaction – This would ensure that any change in the servicer would not be an additional drag on the adequacy of funds available in the transaction for meeting investor payouts.
- Adhering to the payment mechanism – All the counterparties involved in the transaction should fully adhere to the payment mechanism/other terms laid out in the transaction documents. The liquidation of the cash collateral/invocation of the guarantee should happen in a timely manner. The bank, where the cash reserve is placed, and the guarantor should also understand the importance of making timely payments to the investors and act immediately upon receiving instructions/notice from the trustee.

Summary

To summarise, the various counterparties involved in the impacted securitisation transactions need to submit themselves to greater discipline and strictly adhere to the terms of the transaction. The timely replacement of the servicer should happen, whenever required. In case the same does not happen, the ratings of the PTCs may get downgraded to reflect the heightened risk. There could also be delays in making payments to the investors. Consequently, the investors would be forced to take a steep valuation hit on these investments. The secondary market liquidity for such investments is anyway limited and the investors may be stuck with these investments for an extended period. This could erode investor confidence in the securitisation market.



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