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Covid-19 pandemic and the resulting economic slowdown pose heightened risk for securitisation transactions

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Covid-19 pandemic poses heightened credit risk for securitisation transactions

The spread of the coronavirus (Covid-19) pandemic and the current country-wide lockdown announced by the Government of India (GoI) for a 21-day period (from March 25, 2020) would result in weakening of the credit quality of the rated pass-through certificates (PTCs) issued in securitisation transactions. Securitisation transactions are typically designed to protect the senior investor payouts even during periods of stress and dip in collections from the underlying loans, through the credit enhancement (in the form of over-collateral, cash collateral and excess interest spread). However, the unprecedented nature of the current situation makes it difficult to ascertain the extent of stress that may result in the economy, as also the period for which the stress may sustain. The adequacy of the credit enhancements would get tested in the coming months. ICRA believes that the dip in the collections would vary across asset classes. Further, the risk assessment of each transaction would be different on the basis of the extent of amortization already achieved in the transaction and the amount of credit enhancement built-up.

Microfinance borrower class expected to be most affected

Borrowers from microfinance institutions (MFIs) are likely to be the worst affected from the Covid-19 pandemic and the resulting 21-day lockdown, given their inherent weak income profile. The joint group meetings that are regularly held and are an important tool to ensure healthy collections have stopped due to the lockdown. Consequently, collections on such micro loans, that are generally through cash payments, will be adversely hit during the lockdown period. Further, MFIs have reduced fresh disbursements which could also impact the repayment ability and willingness of the borrowers. As the daily livelihood of the borrowers would be most severely impacted during the lockdown, their ability to make good the past payments once the lockdown lifts will also diminish. Most of the securitisation transactions involving MFI loan receivables have their principal payout promised at the end of the transaction so that an interim drop in collections would not lead to an immediate default on the transaction (interest payouts are promised on monthly basis). Nevertheless, the credit quality of the PTCs could significantly worsen if the severity and the longevity of the Covid-19 pandemic is much higher considering recovery from loan contracts that slip into harder delinquency buckets (90+dpd) would become difficult. Further, MFI loan-backed securitization transactions carry a relatively higher dependence on the Servicer; thus, apart from the underlying pool performance, the credit ratings on the PTCs in such transaction are also sensitive to any material deterioration in the credit rating of the Servicer.

Other asset-backed securities (ABS) remain at moderate risk though an elongated period of lockdown would be a credit concern

The impact of Covid-19 pandemic is expected to be moderate on the securitisation transactions backed by vehicle loan receivables. Construction equipment vehicles and MHCVs involved in transporting of non-essential commodities like mining and construction are likely to face revenue losses during the lockdown period. However, in view of the GoI’s push to ensure the supply of essential commodities, it is expected that vehicles involved in transporting essential commodities will be able to continue the business. Thus, a large portion of LCVs (used in intra-state movement) and some portion of MHCVs (used in inter-state movement) are expected to be functional during the lockdown. Nevertheless, the impact of Covid-19 on the overall economic growth would eventually translate into an increase in stress on the commercial vehicle asset class. Most of the PTC transactions in this asset class have their principal promised monthly and a dip in collections is likely to put pressure on the PTC payouts in the near term; nevertheless, the cash collateral provided in these transactions should be able to absorb the same, though a prolonged period of economic slowdown would have a bearing on the credit quality of the PTCs.

Securitisation transactions backed by small business loan (SBL) receivables would also be affected during the lockdown period as operations of these businesses would largely come to a standstill. Nonetheless, if the lockdown does not persist for a longer period, a high proportion of the borrowers are expected to be able to meet their repayments once operations restart. Further, certain SBL loans have a collateral as security (property, machinery etc) and also have a longer tenure allowing for eventual recovery even from serious delinquent loans. PTC transactions in this asset class also typically have their principal promised on final maturity date and thus an interim fall in collections would not create immediate pressure in these transactions.

Securitisation transactions backed by housing loans expected to have relatively lower risks, though transactions backed by loans against property could still see higher slippages

Amid the nationwide lockdown due to the Covid-19 pandemic, the collections from housing loans (HL) are expected to be lesser impacted than other asset classes as majority of the collection happens via NACH/online credits/debits. The salaried borrower class is expected to be most resilient in the current environment whereas the self-employed borrower class may still see some stress. Collections in affordable housing segment are expected to be more impacted on account of the weaker financial profile of the borrowers (cash salaried and smaller self-employed) in this segment. Nonetheless, the securitisation transactions backed by housing loans are expected to have relatively lower risks supported by the diversification of the borrower category (self-employed and salaried) in the pools as well as geography Also, the presence of collateral, which is usually the self-occupied residential house, should incentivise the borrower to prioritise repayments on this loan over certain other claims on its cashflows. However, a prolonged pause in business activity may impact the income and employment status of even salaried customers; those employed in industries which are heavily impacted by the Covid-19 pandemic, such as hotel, tourism, aviation, real estate, automobile etc., could face severe salary cuts/delays or job losses, impacting their debt-servicing capacity.

ICRA expects delinquencies in loan against property (LAP) segment to be relatively higher than housing loan segment as businesses would be under more pressure with fall in the income levels due to the economic slowdown. Thus, securitisation transactions backed by LAP would also face some near-term stress. Nonetheless, the long tenure of these transactions as well as presence of adequate collateral in form of property provides buffer from principal losses on the underlying loans.

Three-month moratorium made available on term loans by the Reserve Bank of India could ease near term pressures if the same becomes applicable to PTCs

On March 27, 2020, the Reserve Bank of India (RBI) announced various measures to ease the pressures being faced by the economy. It allowed for lenders to provide a three-month moratorium on term loans to its borrowers, post a Board approval. In the event these directives are extended to PTCs with the investor's consent then it could alleviate the near-term pressures for the securitisation transactions. It would be prudent for investors to provide the moratorium on PTC payouts as delinquencies are bound to increase over the near term though with varying sharpness depending on the asset class. While the securitisation transactions would have credit enhancement available to take care of some shortfalls in cash collections, the early use of the credit enhancement could impact the credit quality of the PTCs over the longer period, thus resulting in possible rating migrations.

Risk categorisation of ICRA-rated securitisation transactions

ICRA has carried out a risk assessment exercise of its rated 254 securitisation transactions that are live based on the asset class and credit enhancement available in the transaction. The transactions have been marked as High, Medium and Low risk which is an indicator on the possibility of a rating downgrade in the near term and also on investors having to face an eventual loss in the transaction.

EXHIBIT: Risk categorisation of ICRA-rated securitisation transactions

Number of live transactions		Cash collateral as % of balance pool principal (CC cover)					
		ABS - MFI		ABS - Non-MFI		MBS	
		<= 20%	>20%	<= 30%	> 30%	<= 20%	>20%
Pool Amortisation	< 25%	25	-	34	-	13	-
	25 – 50%	11	-	28	-	6	25
	> 50%	16	21	31	31	9	4

**10 ABS and 4 MBS pools that are rated [ICRA]D at present have been excluded from the above table; For above classification, ICRA has used the Jan-20 payout data and also transactions rated in Q4 FY2020*

Transactions with high risk = 52

Transactions with medium risk = 114

Transactions with low risk = 88

The securitisation transactions backed by MFI loan receivables that have seen lesser than 50% of pool amortisation so far and thus have relatively lower credit enhancement build-up are expected to be at the highest risk due to the disruptions being caused by the coronavirus pandemic. Even transactions that have seen higher amortisation but the CC cover is still lesser than 20% are deemed to be at high risk since the break-even collection efficiency for majority of such transactions are 50% ~ 60%. The risks reduce for transactions that are heavily amortised and have a sufficient credit enhancement build-up in the transaction.

For securitisation transactions backed by non-MFI loan receivables (vehicles, tractors, SBL, gold loans etc), ICRA believes that those transactions which have amortised by more than 50% and have a CC cover of more than 30%, are relatively less risker owing to the high CC buildup. The other transactions are deemed to carry medium risk. There are certain transactions that have seen high pool amortisation but still have a CC cover of less than 30% due to either lower initial CC assigned in the structure or CC being reset in these transactions as per the RBI guidelines. ICRA expects the securitiation transactions backed by loan against mortgage receivables (i.e. housing loans, affordable housing loans and loan against property) to be at least risk given the relatively better borrower category, the longer tenure of the loans which would allow for recovery and availability of collateral to make good the losses.

ICRA

ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

Alliance with Moody's Investors Service

The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder. The participation of Moody's is supported by a Technical Services Agreement, which entails Moody's providing certain high-value technical services to ICRA. Specifically, the agreement is aimed at benefiting ICRA's in-house research capabilities, and providing it with access to Moody's global research base. The agreement also envisages Moody's conducting regular training and business seminars for ICRA analysts on various subjects to help them better understand and manage concepts and issues relating to the development of the capital markets in India. Besides this formal training programme, the agreement provides for Moody's advising ICRA on Rating-products strategy, and the Ratings business in general.

The ICRA Factor

Our services are designed to

- Provide information and guidance to institutional and individual investors/creditors;
- Enhance the ability of borrowers/issuers to access the money market and the capital market for tapping a larger volume of resources from a wider range of the investing public;
- Assist the regulators in promoting transparency in the financial markets;
- Provide intermediaries with a tool to improve efficiency in the funds raising process.

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