Treatment of securitisation when rating finance companies

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Executive summary

The effect of securitisation on the balance sheets of finance companies is a crucial credit quality consideration, given that securitisation is a key funding source for non-banking finance companies (NBFCs) and housing finance companies (HFCs) in India.

Securitisation essentially involves the legal transfer of assets (or receivables) by an originating institution to a third party, typically a special purpose vehicle (SPV). This can be done either through issuance of securities (or pass-through certificates [PTCs]) that are claims against specific asset pools or by a direct assignment of loan assets.

Securitisation benefits the resource profile of the originators, primarily by increasing the diversity and flexibility of their funding sources, enhancing liquidity and reducing funding costs. Securitisation may improve credit quality by positively influencing asset and data management in the long term, thus potentially enhancing the efficiency and profitability of the originators.

Securitisation also improves the asset liability maturity profile of originators (especially HFCs) as long-term assets are replaced by cash. In addition, transferring the credit risks on the assets securitised frees the capital required to maintain those assets, which is termed as 'capital relief'.

CRISIL Ratings' analysis includes an assessment of the impact of securitisation transactions on the scale and asset quality, earnings, capital position, and funding and liquidity of the originator. This comprises assessment of the risks (legal and practical) retained by the originator and the quantum of capital that would be economically appropriate to balance these risks, irrespective of whether the assets are off-balance sheet or on-balance sheet.

Criteria for assessing the impact of securitisation

CRISIL Ratings evaluates the impact of securitisation[1] on the scale and asset quality, capital, earnings, funding and liquidity of the originator.

Impact on scale and asset quality

As the securitised assets continue to be serviced by the originator, the borrower's relationship continues with the originator. In this backdrop, while analysing the size and scale of the operations, CRISIL Ratings analyses the company on the basis of its assets under management that includes on balance-sheet assets as well as securitised assets.

As part of the asset quality assessment, in order to get the correct picture of the company's origination, underwriting and collection capabilities, CRISIL Ratings analyses the asset quality metrics of the company on a managed basis including securitised contracts. For companies that rely very heavily on securitisation, CRISIL Ratings may also consider the performance of the on balance-sheet assets if their performance is at a significant variance with the securitised assets.

[1] *For accessing the previous published document on 'Treatment of securitisation in CRISIL's ratings of finance companies', kindly follow the link: https://www.crisil.com/content/dam/crisil/criteria_methodology/criteria-research/archive/CRISIL-Ratings-research-treatment-securitization-finance-cos_feb2018.pdf*

Impact on earnings

Originators in securitisation transactions typically retain residual benefits in the securitised loans in the form of upfront premium/profit or excess interest spread. As per the revised guidelines on securitisation issued in 2012, the profit/premium can be recognised based on amortisation of principal and losses incurred as well as specific provision requirements on the securitisation exposures at the end of every fiscal. For direct assignment of loan assets, the entire excess interest spread can be recognised upfront in the profit and loss account. Additionally, a part of the risk is retained by the originator in the form of investment and credit enhancement. The originator needs to make adequate provisions to cover these risks. To factor in these aspects, CRISIL Ratings evaluates the return on managed assets for measuring the profitability of NBFCs and HFCs with an off-balance sheet loan portfolio. Also, profitability is assessed without factoring the upfront excess interest spread. Apart from reported total assets, managed assets include the off-balance sheet portion of loan assets under management.

Impact on capital

In its assessment of the capital position of finance companies, CRISIL Ratings employs a broad-based approach that goes beyond the on-book gearing. The gearing is evaluated for impact if the off-balance sheet securitised/assigned assets were to be brought back on the balance sheet. The adjusted gearing is calculated by considering off-balance sheet assets as part of total external debt. In the Indian context, the credit enhancement is typically provided by the originators (unlike third-party credit enhancement providers in the international context).

While the capital treatment of the credit enhancement is defined by the Reserve Bank of India, CRISIL Ratings evaluates the risks retained by the originator (in terms of credit enhancement provided, assumptions on credit losses, and the like) by reviewing the performance of the various securitisation transactions.

Impact on funding and liquidity

Funding diversification is one of the important advantages of securitisation for finance companies. Besides enhancing funding options, securitisation also helps an originator manage its asset liability maturity profile by perfectly matching pay-outs with receivables from underlying loans. However, these benefits can be illusory if a company relies too heavily on securitisation or any other single funding source.

About CRISIL Limited

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We are majority owned by S&P Global Inc., a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

CRISIL Ratings pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we set the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 33,000 large and mid-scale corporates and financial institutions. We have also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and infrastructure investment trusts (InvITs).

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