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Credit alert

Legal interpretation challenges continue even as MCA clarifies on securitisation obligations in insolvency proceedings

A credit alert is CRISIL's opinion on a sharp and specific development. It conveys that CRISIL will revert shortly on the impact of the development on the ratings of those affected.

On January 28, 2020, CRISIL downgraded its ratings on pass-through certificates (PTCs) issued by Nirmaan RMBS Trust – Series V – 2014 to 'D'. The PTCs are backed by home-loan receivables originated and serviced by Dewan Housing Finance Corporation Ltd (DHFL), an entity currently undergoing the Corporate Insolvency and Resolution Process (CIRP). The PTCs continue to be in default after their February 2020 payouts, and despite the Ministry of Corporate Affairs (MCA) issuing a much-awaited notification on January 30, 2020, clarifying the treatment of third-party assets in insolvency proceedings.

Though pool collections have remained healthy (collection efficiency steadily above 99% over the past six months), PTCs backed by the aforementioned loan receivables did not receive their dues in full owing to unprecedented legal interpretation challenges that have evolved in recent months. The legal interpretation challenges highlighted in *Table 1* resulted in a part of the collections from the securitised pools and the credit enhancement in the structure being inaccessible to the trustee, which thwarted timely payouts to PTC holders.

While the MCA notification is an important step in resolving the challenge of legal interpretation, grey areas remain.

CRISIL had, through press releases on October 22, 2019, and December 23, 2019, underscored the challenges that had emerged in the securitisation market after payment delays in DHFL-originated PTC transactions, their potentially crippling implications, and called for swift remediation.

It is crucial now that policy makers and regulators address the pending issues before the securitisation market, which has been growing very well of late, is derailed.

Chronology of events

October 10, 2019	The Bombay High Court restricted DHFL from making payments to secured and unsecured creditors, except where payments are made on a <i>pro rata</i> basis to all secured creditors.
Payout status post the order	<p>Despite the order being silent on payouts to securitisation transactions, DHFL stopped depositing collections on securitised assets into the collection and payout account (CPA) of the trusts based on the legal counsel's interpretation of the order.</p> <p>This effectively denied PTC-holders access to the cash that was rightfully theirs, which was held by DHFL for the benefit of the PTC-holders. Several transactions were affected, triggering sharp downgrades and defaults on the ratings of securitised instruments.</p>
November 13, 2019	The High Court granted ad-interim relief to investors in securitisation transactions by directing DHFL to make payments for present as well as future dues as per assignment agreements executed by it.

Payout status for November 2019 post the ad interim relief	Given the clear directions of the High Court, DHFL resumed depositing collections into the trust accounts. These were utilised to make payments to the PTC-holders and to top-up cash collateral where required.
December 3, 2019	Just as a semblance of normalcy was returning to the market, the Mumbai bench of the National Company Law Tribunal (NCLT) admitted the application filed by the Reserve Bank of India (RBI) to initiate insolvency proceedings against DHFL.
Payout status post the NCLT order	<p>The Insolvency and Bankruptcy Rules (Insolvency and Liquidation Proceedings of Financial Service Providers and Application of Adjudicating Authority), 2019 are clear that third-party assets held in trust are outside the scope of the liquidation estate and not subject to any moratorium in payments. Despite this, DHFL again stopped funding the CPAs, citing the central government notification relating to Rule 10 (pertaining to dealing third-party assets) is still awaited. The PTC-holders' access to cash collateral (typically held in trust by the originator / servicer) has also been hampered.</p> <p>Several transactions were affected, with many instruments in default.</p>
January 30, 2020	The MCA issued a notification on Rule 10, covering the manner of dealing with the third-party assets in the custody or possession of financial service providers undergoing CIRP. The notification requires the administrator to, among other things, (i) transfer receivables collected under securitisation transactions in accordance with the terms and conditions of those transactions and (ii) transfer 'assets of third parties' in its custody or possession in accordance with the relevant contracts.
Payout status after MCA notification	<p>In compliance with the MCA notification, DHFL has resumed depositing, at least partly, the collections received to the CPAs.</p> <p>However, citing the absence of explicit notification regarding treatment of credit enhancements under securitisation transactions, the moratorium on usage of credit enhancements continue. Despite the contractual 'held in trust' nature of credit enhancement and the notification on 'assets of third parties' (which by definition includes assets held in trust), PTC-holders' access to these funds remain restricted, leaving securitised instruments highly vulnerable.</p>

Recent MCA notification a step in the right direction, but not a panacea

The much-awaited notification relating to Rule 10 issued by the MCA on January 30, 2020, instructs the administrator to honour all contractual obligations of a servicer in securitisation transactions. The notification explicitly requires the administrator to transfer receivables collected in accordance with the terms and conditions of the securitisation transactions.

Legal counsels that CRISIL interacted with said the notification, together with the Insolvency and Bankruptcy Code, provides ample clarity on the treatment of 'third-party assets' and assets 'held in trust', including cash collateral. It provides unhindered access to pool collections and cash collateral to PTC holders. Accordingly, CRISIL continues to receive unqualified bankruptcy-remoteness opinion on securitisation transactions.

The administrator of DHFL, however, has taken the view that credit enhancement should not be used to make PTC payouts citing absence of an explicit mention of it in the notification. Credit enhancements, despite their 'held in trust' nature, are not being considered as 'assets of third parties', and are not treated as set out in the notification. Consequently, there continues to be a moratorium on the use of credit enhancement.

Where DHFL continues to be the servicer, the waterfall mechanism of the transaction is not being complied with, and collections from the securitised pool of receivables are only partly being transferred to the CPA. Internal forms of credit enhancement (excess interest spread and principal subordination in the form of over-collateralisation or junior tranche) are not being passed along to the trust account to provide support to investor payouts and payment of senior costs such as servicer fees. Consequently, even if collection shortfalls from the securitised pool of receivables are low, the promised payouts to investors can't be made in full and PTCs would be in default.

Where servicing has been taken over by a third party, 100% of the collections made by the servicer is available for investor payouts. However, external credit enhancement (cash collateral) remains out of reach of the trustee, leaving PTCs issued under such transactions highly vulnerable to collection shocks.

Credit enhancement – both external and internal forms – are expected to remain inaccessible for making investor payouts until authorities concerned provide clarity on interpretation of the notification.

Fundamental credit quality of the securitised assets remain excellent

If the legal interpretation was not a challenge for the servicer to honour contractual obligations as envisaged at the time of securitisation, the performance of the PTCs would have remained robust till date. That would be despite the default and initiation of the CIRP on the servicer:

- The three-month average monthly collection ratio (MCR¹) of the underlying pool of receivables has been steadily above 99% even after several months of financial turmoil at the servicing entity (*see table below*)
- The external form of credit enhancement in the structure (in the form of fixed deposit lien marked with the trustee and 'held in trust' by the servicer) is sufficient to make timely promised payments to the PTCs for more than 18 months (even assuming nil collections from the securitised pool)

Performance of the CRISIL-rated pool originated and serviced by DHFL post default

Collection month	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Jan-20
MCR	100.1%	98.5%	100.9%	99.2%	100.1%	99.5%	100.4%	99.7%

Unless urgent clarification is provided, the securitisation market could be impacted

Widespread defaults driven by the futility of structural features embedded in securitisation transactions, and prolonged legal tangles could dent investor confidence. Any disruption in the securitisation market, which has been the lifeline of capital-starved non-banks in recent months, has implications for the financial sector and the economy.

A comprehensive notification covering all aspects of securitisation and requiring all counterparties to securitisation transactions (including administrators and resolution professionals) to honour all contractual obligations under securitisation transactions is critical to support growth of the securitisation market.

A clarification on the treatment of credit enhancement is the immediate necessity.

¹ MCR = Monthly collections in the pool / Monthly billings

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