Ratings

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Securitisation resilient despite roadblocks

Changing demand-supply dynamics help navigate the challenges

Overview | Fiscal 2018

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A challenging year, made noteworthy by burgeoning non-PSL securitisation

After posting a compound annual growth rate (CAGR) of 53.5% between fiscals 2015 and 2017, the Indian securitisation market hit the brakes last fiscal. Fiscal 2018 saw Rs 95,100 crore of transactions (7.2% lower on-year), of which Rs 84,700 crore was retail asset securitisation (6.5% lower on-year) and the balance was primarily future flow structured transactions.

Three major factors contributed to the drop in securitisation volumes last fiscal.

First, the traded volume of Priority Sector Lending Certificates (PSLCs) zoomed to 3.7 times that in fiscal 2017. Higher reliance of banks on PSLCs to meet their priority sector lending (PSL) mandate, bypassing the securitisation route, kept demand for PSL asset securitisation muted.

Second, in marked contrast to previous years, yields on pass through certificates (PTCs) hardened during the fourth quarter of fiscal 2018, with originators having to offer 25-50 basis points (bps) higher yield compared with prior quarters at the same rating level for similar asset classes. The higher ask in terms of yields prompted some originators to pare their securitisation plans for the quarter, while a few investors adopted a wait-and-watch approach in the steadily rising interest rate environment, impacting retail asset securitisation volumes. Only ~Rs 26,000 crore of securitisation happened in the fourth quarter of last fiscal, compared with ~Rs 36,000 crore in the corresponding year-ago quarter.

Third, ambiguity over the applicability of Goods and Services Tax (GST) on securitisation transactions dealt a heavy blow. While most originators relied on opinion from independent market participants to return to the market in the second half of the fiscal, a few large players kept away, awaiting official clarification from the GST Council. These large players had accounted for ~20% of the overall retail securitisation volume in fiscal 2017.

While the growing popularity of PSLCs was expected to dampen demand for PSL asset securitisation, the turmoil on account of rollout of GST and hardening of interest rates in the fourth quarter came as a bit of a surprise.

Despite these roadblocks, the volumes dropped only modestly, by 7.2%, as the market adapted to the shifting demand-supply dynamics, as listed below, revealing its inherent resilience.

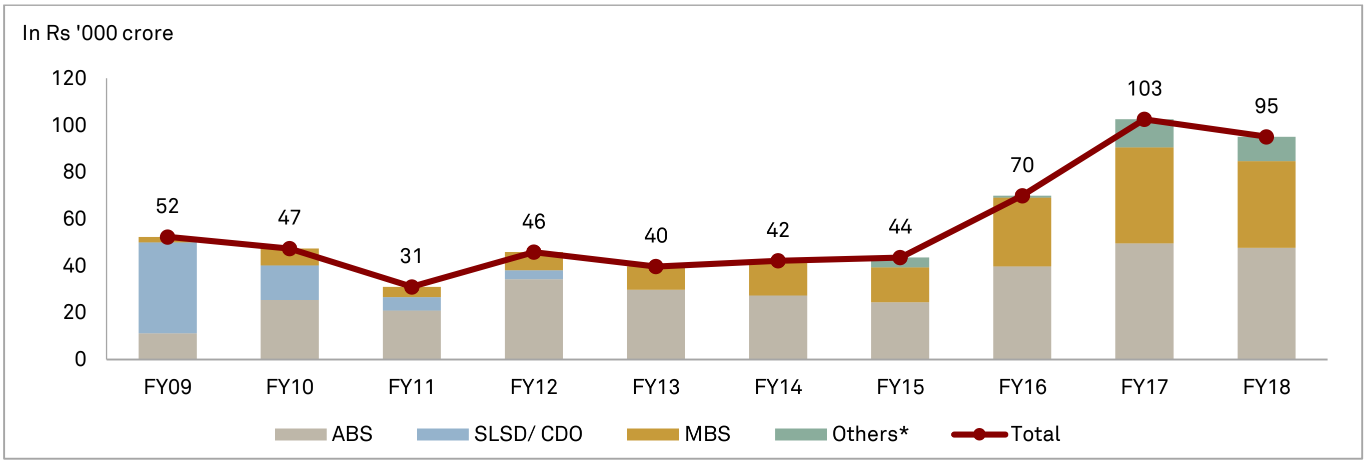
1) Robust appetite from all investor classes – banks, mutual funds, treasuries of non-banking financial companies (NBFCs), insurance sector – for non-PSL asset backed securitisation partly offset the subdued demand for PSL assets

2) Reliance of large housing finance companies (HFCs), with the exception of players that stayed away on account of GST concerns, on securitisation to meet their funding needs rose steeply and somewhat counterbalanced the drop in volumes on account of GST

3) With asset quality pressures easing, investor confidence in the microfinance industry progressively returned; both NBFC treasuries chasing yield and banks hungry for PSL assets (especially assets eligible under the small & marginal farmers segment and agriculture segment) lapped up microfinance receivables-backed pools

4) New asset classes such as education loans and consumer durables loans debuted in the securitisation market last fiscal, while personal loans and collateralised obligations returned to the market after several years, and found takers in spite of the challenging environment

Securitisation volume still holding strong



**Includes structured transactions such as future flow and commercial mortgage backed securities transactions*

Source: CRISIL estimates

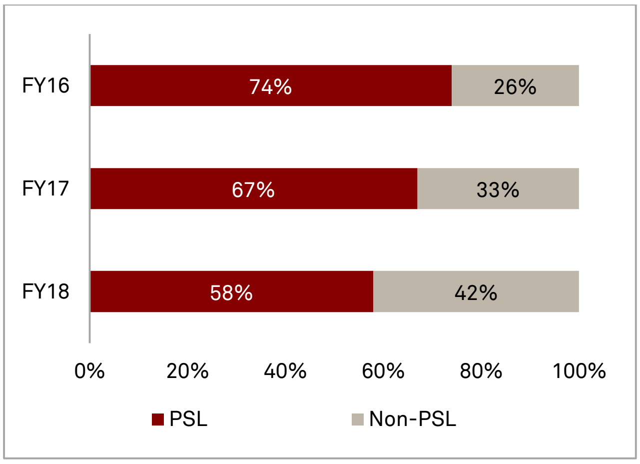
Non-PSL securitisation comes of age…

Securitisation transactions backed by non-PSL assets are increasingly making their presence felt in a market that has traditionally been driven by PSL demand from banks. The share of non-PSL assets in retail securitisation reached a high of 42% last fiscal, up from 33% in fiscal 2017 and 26% in fiscal 2016. The steadily rising presence of non-PSL asset securitisation is primarily on account of two demand-side drivers:

1) Demand from banks buying securitised pools as a means to expand their retail asset portfolio – These banks are more focused on securing long tenure assets from segments such as mortgages that have displayed steady asset quality, and less focused on the PSL eligibility of the assets. This segment accounted close to two-thirds of the non-PSL securitisation last fiscal.

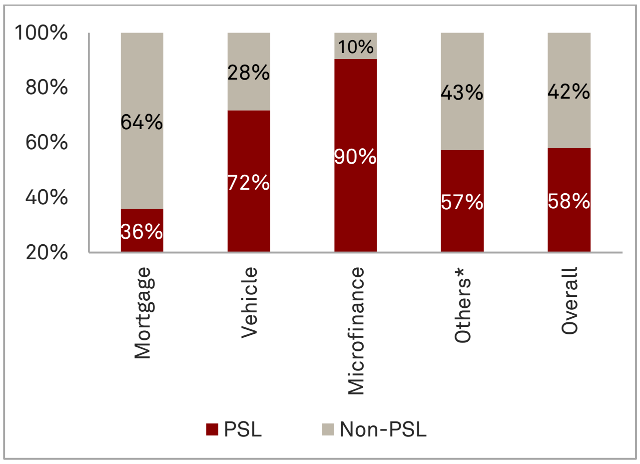
2) Demand from investors such as mutual funds, NBFC treasuries and certain private banks chasing yield – Given that the yields on PTCs backed by non-PSL assets are 50-100 bps higher than those on PSL-backed PTCs of the same originators, these yield-hungry investors are flocking to non-PSL asset-backed securities. Investments by this category of investors spans across asset classes and rating categories. While traditionally securitised asset classes such as commercial vehicle loan receivables, car loan receivables and microfinance loan receivables are still the most sought after segments, newer asset classes such as education loan receivables, cash loan receivables and consumer durables loan receivables are also finding takers.

Retail asset securitisation volume by PSL eligibility



Source: CRISIL estimates

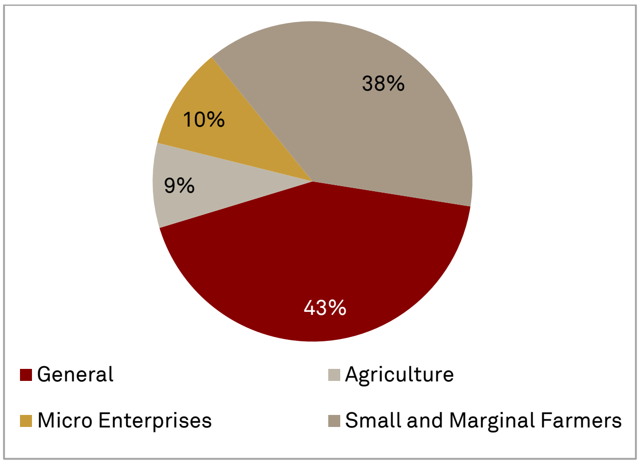
Asset class-wise break-up of PSL eligibility for fiscal 2018 retail securitisation market



**Others includes education loans, consumer durables, cash loans, tractor loans, small business loans, among others*

Source: CRISIL estimates

Fiscal 2018 PSLC traded volume by segment



Source: CRISIL estimates

…as PSLCs grow in popularity

PSLC volumes skyrocketed to Rs 1.86 lakh crore in fiscal 2018, up from Rs 49,800 crore in fiscal 2017.

PSLC-General and PSLC-Small and Marginal Farmers (SFMF) remained the largest traded segments within PSLCs. On the supply side, private sector banks with excess PSL in the general category and Regional Rural Banks (RRBs) with excess in SFMF assets were the sellers.

PSLC-Agriculture and PSLC-Micro Enterprises segments upped their share in overall traded volume from 12% in fiscal 2017 to 19% in fiscal 2018. These segments benefited from increased supply from SFBs last fiscal, compared to fiscal 2017.

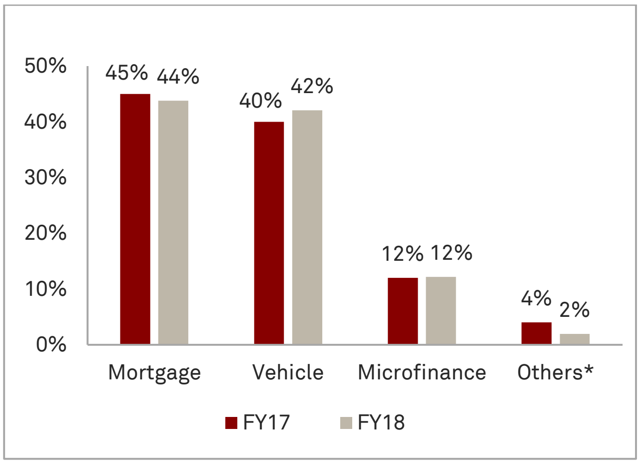
Given the acute shortage of assets in the SFMF segment and the consequently higher demand for them, pricing in this segment was the highest throughout the year, followed by PSLC-Agri, PSLC-Micro and PSLC-General, in that order. Average pricing across segments ranged from 0.1% to 0.4% in the fourth quarter of the fiscal.

Vehicle segment holds its own despite the tempered PSL-driven demand

The vehicle loan receivables-backed securitisation is dominated by the commercial vehicle (CV) segment. The segment has long been a favourite of PSL seeking banks as these loans typically comply with micro, small and medium enterprises (MSME) priority sector criteria. However, overhang from the PSLC market kept demand for PSL-compliant CV loans subdued last fiscal.

The demand drop in the PSL space was largely offset by a pickup in demand from mutual funds and the insurance industry. Non-bank investor interest in the mature vehicle segment – including CVs, cars and construction equipment – was robust, to the extent that close to a fourth of vehicle loan securitisation volumes was lapped up by the mutual fund/ insurance industry last fiscal. The yields on these investments have ranged from 7.5% to 9.5% depending on the asset class and originator. However, participation of these investor classes still remains limited to AAA (SO) rated PTCs originated by large marquee NBFCs.

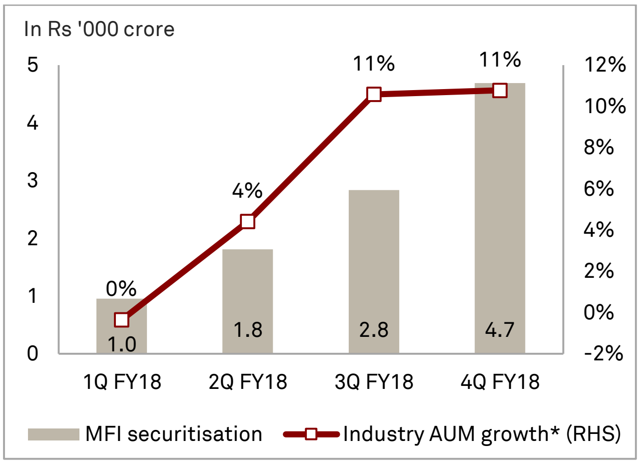
Retail securitisation volume by asset class



**Others includes education loans, consumer durables, cash loans, tractor loans, small business loans, among others*

Source: CRISIL estimates

Quarterly securitisation volumes of microfinance asset class



Source: CRISIL estimates, MFIN Micrometer

**Industry AUM excludes SHG-Bank linkage*

Microfinance volumes perk up as asset quality concerns recede

Volume of microfinance securitisation picked up sharply towards the second half of the fiscal after remaining subdued for three quarters immediately following the demonetisation announcement. As growth returned to the industry and asset quality concerns eased, investor sentiments improved. Both banks seeking PSL assets and NBFC treasuries looking for yield returned to the market, buoying securitisation volumes.

By the end of the year, large NFBC-MFIs ended up raising funds amounting to 20-50% of their year-end assets under management (AUM) through the securitisation route.

Volumes also benefited from several small finance banks (SFBs) re-entering the market to meet their funding needs, to diversify the investor base and with an eye to keep the next year's PSL target to the minimum by moving assets off balance sheet.

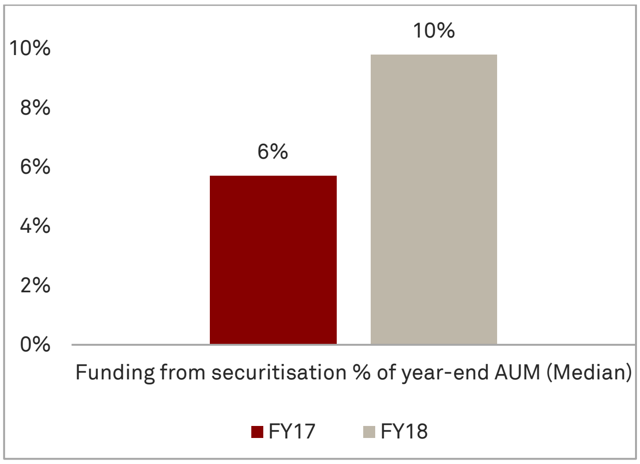
Mortgage-backed securitisation volumes fall sharply

The uncertainty regarding tax implication under GST regime was acutely felt in the mortgages segment – a secured asset class backed by immovable property – as certain large mortgage players, which contributed ~40% of total mortgage-backed securities (MBS) volume of fiscal 2017, did not participate in the market during the second half of fiscal 2018. Consequently, the MBS volume dropped by ~9% on-year to Rs 37,400 crore.

The drop in volumes was to a large extent cushioned by higher originations by other major HFCs active in the securitisation space. Encouraged by robust demand from banks, some larger HFCs increased their reliance on securitisation as an alternative avenue of funding to support their growth, so much so that the median funding through securitisation to AUM for the largest MBS originators in fiscal 2018 rose 4% on-year.

An estimated 93% of the MBS securitisations were through the direct assignment (DA) route, directly adding to the buying banks' loans and advances book. Only 7% of the overall mortgage securitisation happened through the PTC route in fiscal 2018, down from 17% in fiscal 2017.

Funding from securitisation of top 5 MBS originators of fiscal 2018



Source: CRISIL estimates

Increasing presence of unconventional asset classes in the securitisation space

The securitisation market, which was historically dominated by banks as investors, is witnessing an expansion of investor base once PTCs became an attractive investment opportunity after clarity on dividend distribution tax emerged in early fiscal 2017. The entry of newer investor segments – mutual funds, NBFC treasuries, foreign portfolio investors (FPIs), insurance industry – with differing risk appetites and return aspirations from the banking industry paved the way for newer, non-PSL compliant asset classes to be sought out in the securitisation space.

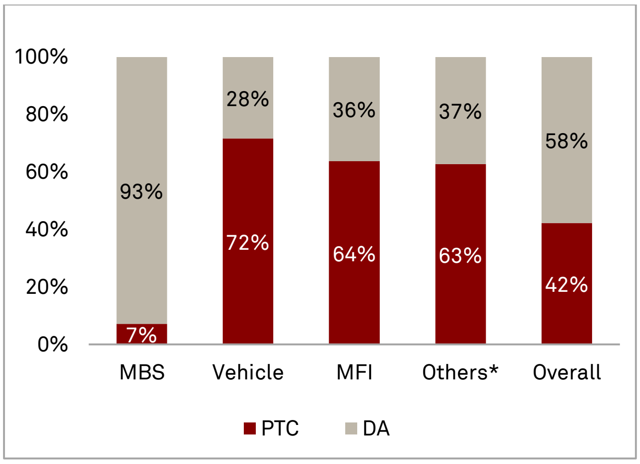
This trend accelerated in fiscal 2018 with several innovative asset classes entering the market. Transactions backed by education loan receivables and consumer durables loan receivables debuted in the country last fiscal. Collateralised obligations and transactions backed by personal loan receivables re-entered the market after a gap of several years.

Although the overall volumes of these non-traditional asset classes is currently small, the demonstrated investor interest in non-AAA rated papers backed by these assets augurs well for the long-term prospects of the securitisation market. The higher yields offered by PTCs backed by these asset classes – in the range of 9-11.5% (50-100 bps higher than similarly rated plain vanilla instruments) – should help attract investors on a sustained basis to such transactions.

Market skewed in favour of DA transactions

The inter-play of numerous factors that impacted the securitisation market last fiscal resulted in the market moving further in favour of DA transactions. The most significant of these factors were: i) the lower appetite for mortgage-backed PTCs as banks looked to bolster their loan book through the DA route and the originators preferred the DA route due to the absence of credit enhancement, and ii) lower demand for PTCs backed by PSL eligible vehicle loan receivables. Although the increased participation of non-bank investors softened the blow, the share of PTC transactions fell to 42% in fiscal 2018 from 47% the previous fiscal.

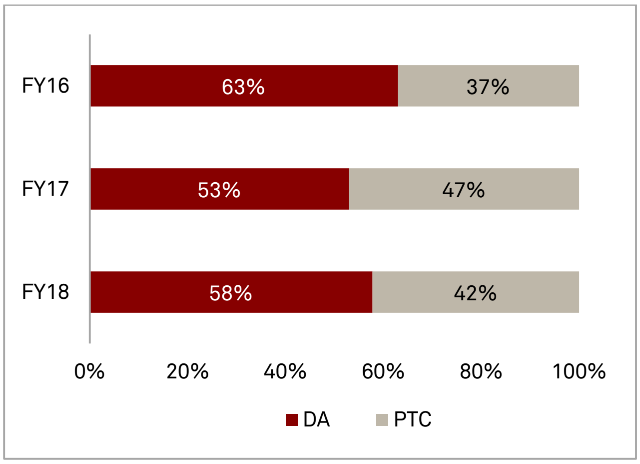
Fiscal 2018 retail securitisation volume by securitisation route



**Others includes education loans, consumer durables loans, cash loans, tractor loans, and small business loans*

Source: CRISIL estimates

PTC-DA split for retail securitisation over the years



Source: CRISIL estimates

Looking ahead

Non-PSL asset securitisation would be the driver of securitisation market going forward, even as PSL asset securitisation remains sizeable.

Non-PSL securitisation would benefit from a widening investor base keen on tapping the PTC market, which offers a premium over the comparable plain vanilla instruments.

Despite the popularity of PSLCs, PSL asset securitisation would continue to find takers, although to a lower extent than seen in the past, in the short-to-medium term. The 'expense' nature of PSLCs, together with pricing volatility, would discourage banks from relying exclusively on the PSLC market to meet their PSL deficit. The increasing PSL requirement of the banking system, with rising targets for foreign banks – i) the introduction of PSL sub-targets for foreign banks with 20 or more branches from fiscal 2019 and ii) the increase in PSL target to 38% from 36% for foreign banks with less than 20 branches – will benefit both PSL securitisation and PSLC markets.

On the regulatory front, the official clarification from the GST Council, categorically stating that securitised assets are not liable to GST, comes as a huge relief to the market. It puts to rest the lingering doubts of certain market participants regarding applicability of GST on securitisation transactions, and should support the transaction volumes this fiscal.

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