

# FIDC

## Finance Industry Development Council

*(A body incorporated as a Self Regulatory Organisation for Registered NBFCs)*

21 June 2010

The Chief General Manager -In-Charge  
Department of Non-Banking Supervision  
Reserve Bank of India  
Central Office, Centre I  
World Trade Centre, Cuffe Parade  
Colaba, Mumbai 400 005.

Madam,

Sub : RBI Draft Guidelines on Securitisation Transactions by NBFCs, dt. 3<sup>rd</sup> June 2010

As you are aware, the Asset Financing NBFCs, (NBFC-AFC) registered with Reserve Bank of India, have joined hands and formed a Self Regulatory Organization (SRO) under the name of Finance Industry Development Council (FIDC). FIDC is an All India body and is registered as a Company U/s. 25 of Companies Act, 1956. Our main objective is to work towards bringing discipline amongst our members by enforcing a model code of conduct, represent the views of the industry to the appropriate authorities where necessary and present a unified face of this sector.

Recognising the role played by the NBFCs engaged in asset financing, RBI has also given a separate classification for Asset financing NBFCs. Please permit us to refer to ourselves as NBFC-AFC for the purpose of this note.

NBFC AFCs have been recognized for their role in India and have carved a niche for themselves in the semi-urban and rural segments of the country. NBFC-AFCs are also playing a vital role in credit dispensation to the poor states/credit starved areas for over 5 decades. They specialize in financing to the Transportation, Agricultural, infrastructure and SME segments and their customer segments include , First time buyers, SRTOs, Agricultural and Weaker sections of the society, involving people who normally either cannot approach banks for their credit requirements or are ineligible for the same .

More than a half of the customers who take loans from the NBFC-AFCs are such customers who are borrowing for the first time in their life and hence are acquiring a productive asset for the first time. NBFC-AFCs, through their local presence and domain expertise, have developed well honed skills to identify such needs and fund them after conducting appropriate due diligence. In fact RBI has repeatedly emphasized the need for credit delivery to the priority sector and the NBFC-AFCs have been playing a very effective role in carrying forward this vital

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policy of RBI through the process of financial dis-intermediation and have accordingly complemented the role of the Banking sector in ensuring the achievement of the desired target lending to the Priority sector.

The two vital players in ensuring such financial inclusion of the deserving segments of the society are the Banks and NBFC-AFCs and each of them have their own strengths, most often complementary. The strength of the Commercial Banks lies in their capability to warehouse the assets owing firstly to their superior capital base and secondly to their ability to access low cost deposits, while the strengths of the NBFC-AFCs lie in their loan origination and servicing skills. Needless to mention, these entities have, over a period of time, developed expertise in identifying the credit needs of this deserving, yet neglected, segment of the customers, efficiently assess the risk attached thereto, tailor make credit products to suit their requirements, lend and recover their instalments. Thus, this unique wholesaler/retailer collaboration model between the banks and NBFC-AFCs has ensured increased flow of credit to under-served, credit starved sections of society, which in turn has helped significantly in creation of Assets and Wealth in rural and semi urban parts of the country and at same time deepen the credit delivery to remote parts of the country.

In this background, securitisation transactions have formed an important source of funding for AFCs and have also ensured the furtherance of the principle of Financial inclusion. They have, as a consequence of their deep penetration and presence in the credit starved semi urban and rural parts of the country been instrumental in credit delivery to the deserving sections of the society. Such a partnership has not only supported in fulfilling the banks' statutory compliance of priority sector lending but has also provided NBFC-AFCs a regular source of funds – primarily by securitising the loans originated by them and also by way of refinance - for carrying on their business.

Needless to mention, the strength of these entities is their ability to source quality customers and serve such customers appropriately from time to time. The fact of their quality sourcing is evidenced through the published data and analysis of the eminent Credit rating agencies in the country that the receivables originated by most NBFC-AFCs have shown consistently excellent performance and exhibit a very high level of credit quality.

The ability of NBFC-AFCs to securitise their pool of receivables with the bankers has resulted in lower dependence on public deposits for financing their business and accordingly in the last few years the deposits growth for the AFCs has been largely muted as compared to their asset growth and asset creation.



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In view of this, the NBFCs, in their desire to cater to the credit needs of their semi-urban and rural clientele, have resorted to Securitisation as an important funding mechanism as under:-

- They provide credit, inter-alia, to the Priority sector, SRTD, Agricultural sector, weaker section in the semi-urban and rural segments of the market.
- They hold the assets in their books generally for a period of 3 months
- The pool of assets is then rated by an approved Credit Rating agency with appropriate Credit enhancements (Usually rated, AAA (SO)).
- The above process of Securitisation has now become the lifeline of the NBFC-AFC sector.
- This is more so, because typically NBFCs have limited ability to raise capital, particularly given the current status of the Capital markets

During the last two years the RBI, with a view to prevent systemic risks, has periodically raised the level of Capital adequacy requirements for Non Deposit taking NBFC-AFCs, from 10% to 12% and further from 12% to 15% by 31<sup>st</sup> March 2011. The need for securitisation is therefore felt even more today in view of such higher CRAR. BUT the suggested stipulations in the draft guidelines on securitisation, pertaining to Minimum Holding period and Minimum holding of residual interest would cause significant stress on NBFC-AFCs.

The draft guidelines prescribe a minimum holding period of 9 / 12 months, where maturity of the loans in the pool securitised is up to 24 months/ more than 24 months. For the purpose of calculating the holding period, the draft guidelines refer to the first instalment due date or the date of full disbursement whichever is later. This effectively means that a loan can be securitised only after 10 / 13 months from the date of originating the loan. NBFCs normally provide vehicle loans for a period of 36 months to 42 months. Currently these loans are offered for securitisation even if the holding period is as low as one or two months. As a rule, these pools are rated by a recognised rating agency. The rating agencies while assigning a rating, consider various aspects like the experience of the originator, recovery performance of past pools, portfolio analysis, composition of the portfolio in terms of asset class, loan to value, seasoning, over dues at the time of securitisation, geographical location, customer profile, etc. They derive significant comfort from the past experience of the originator, based on the overall portfolio analysis. Past performance is a lead indicator of future performance. Based on this they assign the rating for the pool, even though the pool per-se may not be a seasoned one.

If the minimum holding period is stipulated at 12 months, as contemplated in the draft guidelines, a pool of assets when identified for securitisation would have a minimum holding period of around 12 -16 months, because one cannot conclude the transaction immediately after the 12th month. Hence the remainder period would be approx 20 months (door to door) and the



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average tenor would be 6 - 8 months (since the run down of the receivables will be faster in the initial months).

Further, in any retail asset pool, the performance of the pool would be quite satisfactory in the initial 18 months. Beyond this period, the delinquency will gradually move up and reach the peak level at 24 months. Hence the stipulation that the pool can be securitised only after 12 months would result in the underlying risk becoming proportionately higher, as compared to a pool that is securitised at 3 months and consequently entail a higher proportion of credit enhancement (as a % of the amount securitised). This implies a lower disposable amount in the hands of the originator.

We invite your reference to CRISIL's research report on behaviour of credit and liquidity shortfalls in ABS pools, a copy of which is enclosed herewith. We reproduce below the relevant portion of the report:

*"Collection shortfalls in a securitisation transaction are broadly divided into liquidity shortfalls, (which arise due to short-term inability of the borrowers to make the payment but are ultimately expected to be received) and credit shortfalls which indicate the borrower's inability / unwillingness to pay over the long term.*

*Also, the median liquidity shortfall, month of peak liquidity shortfall for Auto financing is 15 months and for CV financing it is 10 months. Further, Auto and CV pools reach around 35-40% of their peak credit shortfalls by the 12<sup>th</sup> month following securitisation and 80% of the credit shortfall is observed at 2-3 years post securitisation. The average seasoning of pools, at the time of securitisation is about 6 months."*

Hence, there is a need for differentiating a retail securitisation transaction from the single loan sell down transaction, which is essentially securitisation of single corporate loan. In such a transaction, the risk is completely dependent on the underlying customer and hence the stipulation of minimum seasoning may be relevant. However, in a securitisation transaction of retail assets, the main comfort for the investor and the rating agency is that the risk is widely distributed, backed by the originators experience in managing such retail assets. Hence the rating of the pool is influenced more by the portfolio performance of the originator than by the performance of the underlying assets in a particular pool.



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To sum up:

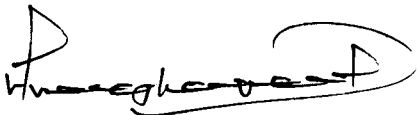
1. Stipulation of Minimum retention period for assets securitised by NBFC-AFCs would put severe pressure on the capital of such companies, restricting their ability to extend loans to the priority sector and weaker sections of the society.
2. NBFC-AFCs need securitisation of their assets constantly to churn their portfolio and provide credit on a continuous basis, since they have limited access to other sources of funds.
3. The Credit enhancement that is prescribed by the rating agencies to offer a rating of "AAA (SO)" appropriately deals with the minimum residual interest as proposed in the guideline.

Considering the above, we request that the stipulations regarding the Minimum Holding Period and the Minimum Retention Requirement are not made mandatory for retail asset pools originated by Asset Financing Non Banking Finance Companies.

We trust that our submissions will receive your favourable consideration.

Kind Regards

Yours sincerely



**T.T.Srinivasaraghavan**  
Chairman

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