

INDIAN COLLATERALISED LOAN OBLIGATION MARKET

CLOs can support credit growth for lower-rated entities; however, participation from more originators and investors needed

SEPTEMBER 2021



Collateralized
Loan
Obligations



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The rating notch-up for the senior CLO PTCs has been 3 to 4 notches from the average rating of the underlying borrowers in the transactions rated by ICRA so far.

Future participation of banks as originators having large exposures to BBB and lower rated corporate entities across industries would remain important to boost the CLO market volumes.



- The domestic collateralised loan obligation (CLO) market has seen limited issuances in the past five-year period unlike the CLO market in the West where the product is well-accepted and has seen a resurgence in issuances in CY2021 post Covid.



- CLO structures have been issued in the domestic market mainly by NBFCs so far. The underlying borrowers in the securitised pools have also been NBFCs.



- The senior tranche in CLO structures have enjoyed higher ratings than the average rating of underlying borrowers due to the presence of multiple borrowers in the pool and availability of credit enhancement in the form of a junior tranche and cash collateral.



- CLOs improve the risk participation in the industry and can be a good tool for boosting credit growth for lower-rated, mainly non-investment grade entities, if more investors and originators enter into the market



- CLOs provide the investors an opportunity to take exposure on new entities and build relationship before lending directly on their balance sheets



- The credit ratings of six CLO transactions rated by ICRA have either been upgraded or reaffirmed so far post issuance.



The collateralised loan obligation (CLO) pass through certificates (PTCs) are instruments issued by a bankruptcy remote SPV/trust that are backed by term loans/bonds issued by an entity (originator). The structure of the CLO PTC is akin to retail securitisation transactions, except that here the pool consists of term loans/bonds provided to other corporate or financial sector entities.



Unlike retail securitisation transactions, the underlying pool, in case of CLO PTC transactions, is more concentrated on an obligor level. Since there are lessor loans in the pool, the role of servicer would be less critical than in a securitisation transaction.



Multiple CLO transactions were seen prior to 2012, mostly backed by a pool with only one underlying borrower. Post the 2012 RBI guidelines on securitisation, wherein single asset securitisation was not allowed², the first CLO PTC issuance happened in September 2017 which was rated by ICRA.

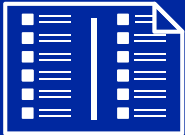


Thus far, ICRA has rated six¹ CLO PTC transactions (**pool principal amounting to Rs. 486 crore**) where the underlying borrowers have been financial sector entities. In these structures, the originators have been NBFCs. For the analysis in this report, we have not considered other concentrated pools usually issued by school financing NBFCs having 40 to 70 underlying borrowers but of a weaker quality.

¹ Accepted ratings only ² Draft securitisation framework released by RBI on June 08, 2020 proposes to allow single asset securitisation

Balance Sheet Transactions

- Bank or non-banking financial company (NBFC) sells a portfolio of corporate loans/bonds it has originated (sometimes with an arranger involved)
- Most of the CLO transactions in India have been balance sheet deals till date

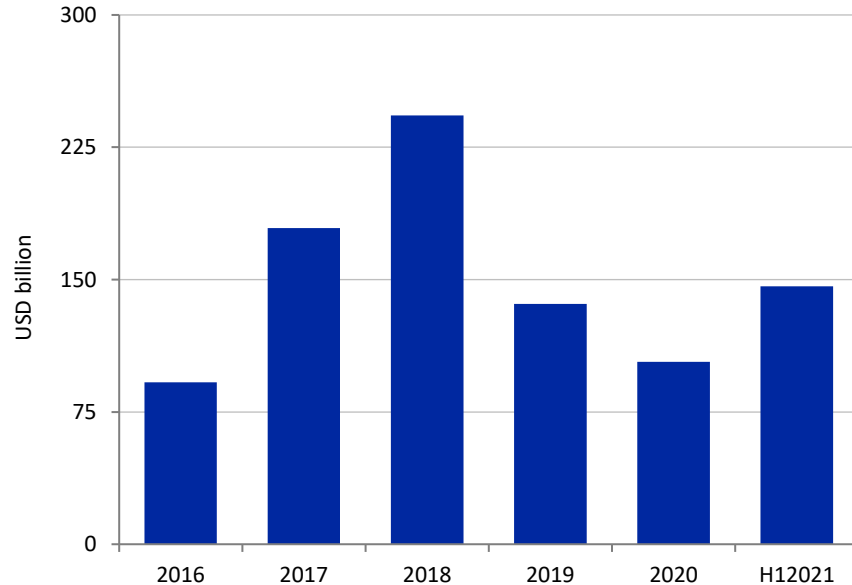


Arbitrage Transactions

- CLO manager uses the funding from the PTCs issued to buy a portfolio of corporate loans/bonds from a range of lenders and the secondary market
- The US and European CLO markets mostly consist of arbitrage transaction deals



Exhibit: Year-wise fresh CLO issuances in the USA (in USD billion)



Source: Moody's Investors Service

- The CLO market is a thriving and well-developed market in the West.
- The US market has the highest share in CLO issuances globally followed by Europe.
- The fresh CLO issuances in the US were particularly strong in CY2017 and CY2018 before witnessing a moderation in CY2019.
- Due to the ongoing Covid-19 pandemic, issuances in the US CLO market witnessed a fall in CY2020. However, in both Q1 CY2021 and Q2 CY2021, fresh issuance volumes have bounced back sharply with issuances in H1 CY2021 crossing the levels of previous two years.
- The issuances in 2021 during the second half are expected to remain strong on account of economic recovery and receding pandemic.
- The Indian CLO market in comparison remains significantly small.

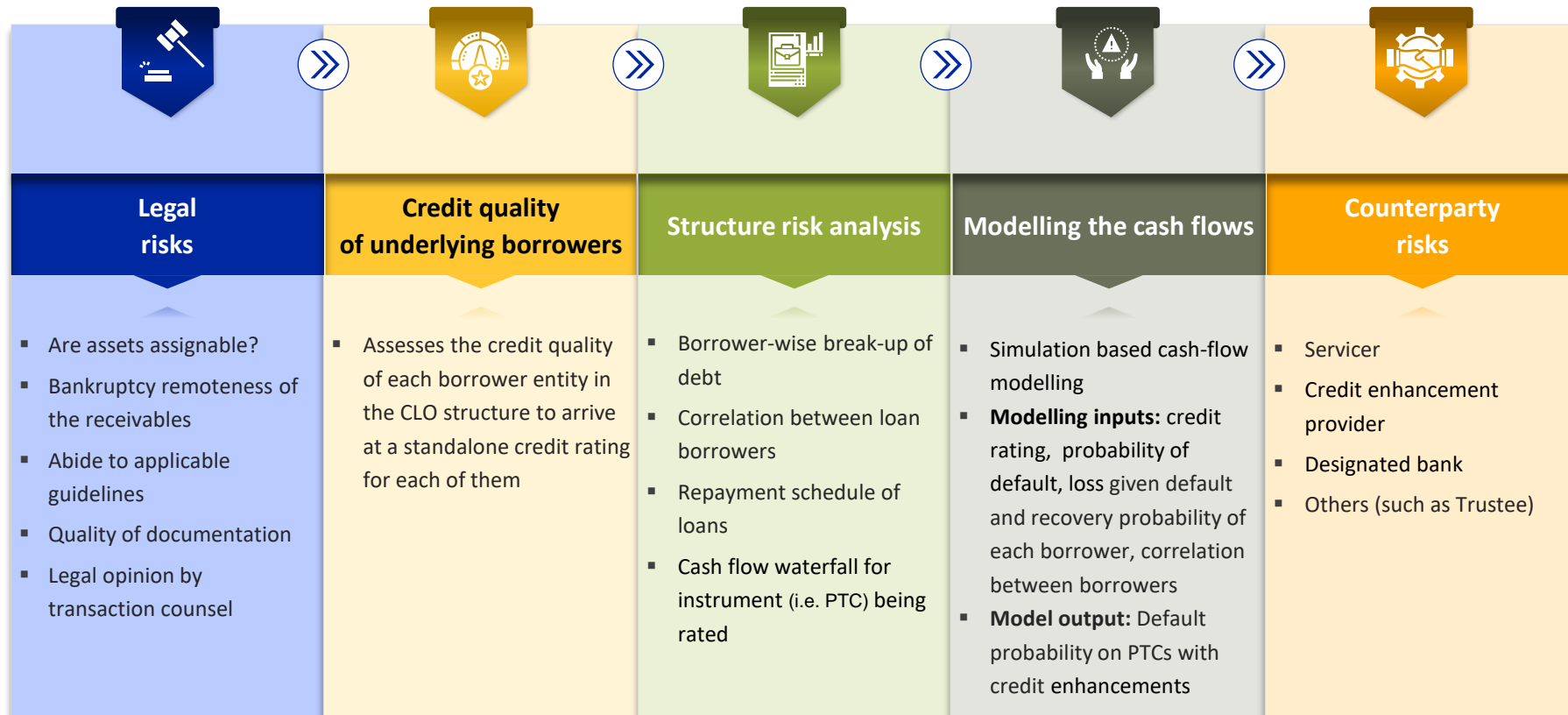
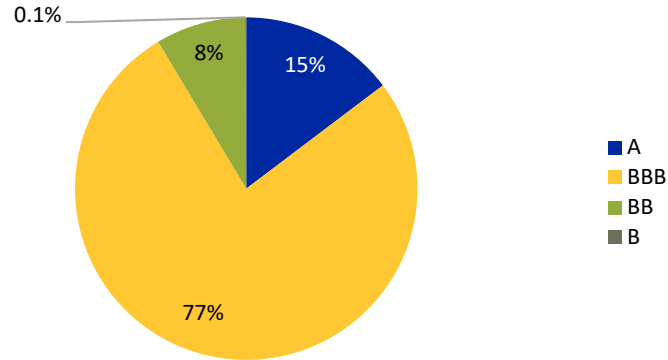
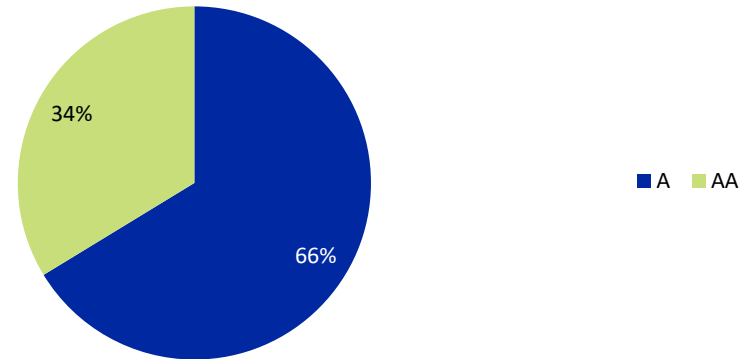


Exhibit: Credit rating category of underlying debt borrowers (by value)



Source: ICRA Research; ICRA rated transactions

Exhibit: Credit rating category of senior PTCs (by value)



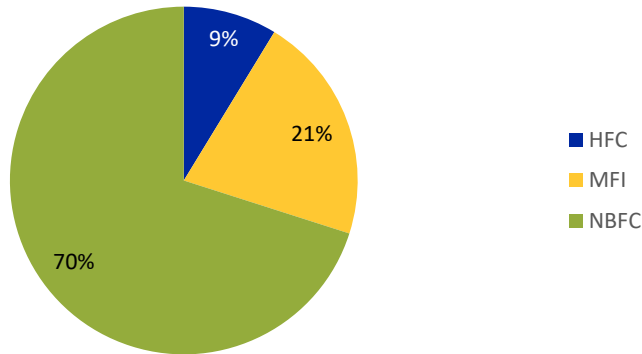
Source: ICRA Research; ICRA rated transactions

- In the CLO transactions rated so far, the underlying borrowers have been rated largely in the BBB category. However, the senior tranche of the PTCs have a credit rating in the A or AA category. The rating notch-up so far has been 3 to 4 notches for senior PTCs and 1 to 2 notches for junior PTCs from the average rating of the underlying borrowers.
- The higher rating for the senior tranche has been possible due to the presence of multiple borrowers in the pool and availability of credit enhancement in the form of a junior tranche and cash collateral which reduces the default probability. For example, default of the senior PTC would occur only if two or three BBB-rated underlying borrowers were to default (as a lower number of default would be absorbed by the credit enhancement) thereby resulting in a higher rating for the senior tranche.

Note: AA refers to AA category of ratings, viz. AA+, AA and AA-; similarly for A, BBB, BB and B category ratings

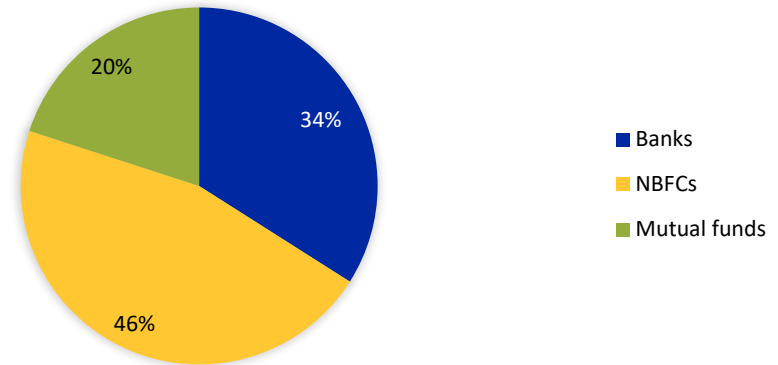
NBFCs a part of underlying borrowers in CLO transactions

Exhibit: Type of underlying borrowers (by value)



Source: ICRA Research; ICRA rated transactions

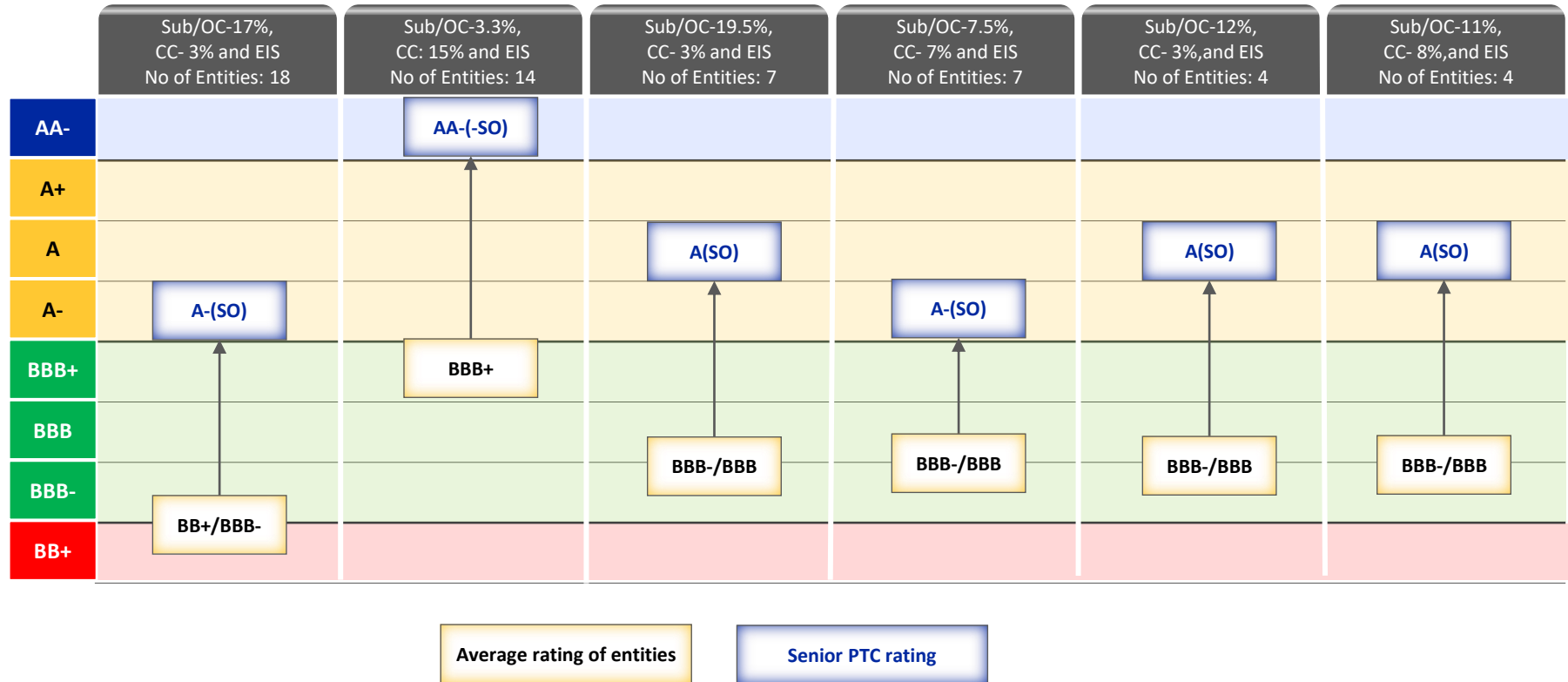
Exhibit: Investor-wise share in senior PTC tranches (by value)



Source: ICRA Research; ICRA rated transactions

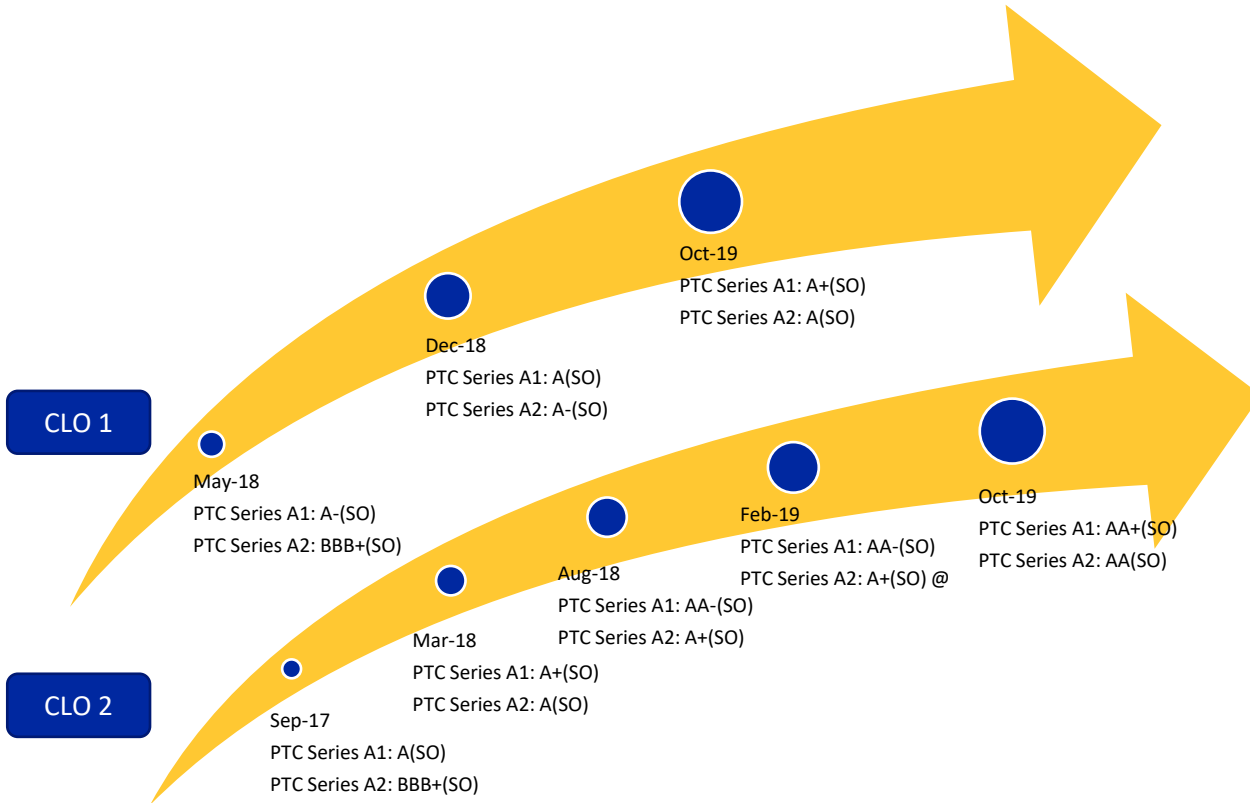
- Non-banking financial companies (NBFC), housing finance companies (HFC) and microfinance institutions (MFI) constituted a major portion of the underlying borrowers in ICRA-rated CLO transactions.
- Investment in senior PTC instruments was mainly by private banks and mutual funds. The participation in junior tranches, wherever available, has been from the arrangers who have been involved in structuring of the transactions.
- Participation of more originators, especially banks with exposure to BBB and lower rated corporate entities across industries, and divergence in investors such as banks, mutual funds and insurance companies, who have the capacity to participate in large-size issuances, remains critical for boosting the domestic CLO market volumes.

Increase in credit rating of PTCs due to availability of credit enhancement



Sub: Subordination, OC: overcollateralisation, CC: Credit Collateral
 Source: ICRA Research; ICRA rated transactions

Rating upgrades seen in ICRA-rated CLO PTCs



Out of the six CLO PTCs rated by ICRA there have been upward rating movements in two transactions. These were the first two CLO PTC transactions rated by ICRA and both these transactions have matured

The rating on the junior tranche of one transaction was put on watch with negative implications due to weakening in credit profile of one of the underlying borrowers. However, the ratings were subsequently upgraded after the borrower made all the payments as per its scheduled obligation.

The PTCs in the balance transactions have been reaffirmed. There has been no CC utilisation in any of the rated CLO PTCs.

@ under rating watch with negative implications



For originator

- Availability of liquidity through sale of loans
- Loans continue to remain on balance sheet and thus the book size does not shrink (applicable for entities following Ind AS)
- Transfer of risk; losses for originator to be limited to extent of credit collateral provided in the structure



For investor

- Able to fund lower credit rated borrowers while enjoying relatively lower risk through availability of credit enhancement
- Faster way to build the asset side of the balance sheet as due diligence need not be time-consuming
- Loans are already disbursed and have a track record of repayment that can be analysed
- Provides opportunity to take exposure on new entities and build relationship before lending directly on their balance sheets
- Even if the credit rating of the underlying borrowers remains the same, the credit rating of the CLO PTC could improve as credit enhancement available against balance amount increases with pool amortisation; this could translate into some capital release for banks
- Dependence on the originator / servicer is lower compared to retail securitisation due to lesser number of loan accounts which could even be escrowed if required



CLOs improve the risk participation in the industry and can be a good tool for boosting credit growth for lower-rated, mainly non-investment grade entities, if more investors and originators enter into the market.

Limitations of CLO transactions

Lack of standardised loan documentations across all banks and NBFCs which otherwise could reduce the pre-securitisation due diligence

Banks may still prefer to directly have a first charge on the assets in case of bankruptcy of the underlying borrower instead of relying on the originator to pursue the claims

Bond market in the country yet to deepen for A-category and lower rated issuances which limits the possibility of pooling such debt issuances for a CLO-like transaction; thus, only lower rated term loans are available for such transactions

Relatively weaker market interest for A-category and lower rated PTC products; resultantly, the credit enhancement required to achieve AAA-rated or near-AAA rated CLO structures may be a deterrent unless the pool has meaningful granularity

As most bank loans and even NBFC longer-tenure loans would have floating interest rates linked to the base rate, the CLO PTCs would have interest rate risk (in case CLO PTC yield is fixed) and basis risk (in case CLO PTC yield is linked to another benchmark)

Limited participation of public sector banks in the PTC market as investors

Need for better investor and originator education given the specialised nature of the product and limited issuances seen so far

Annexure | List of ICRA-rated CLO transactions (as on September 20, 2021)

Transaction/Trust Name	Originator	Rated month	PTC Series A1 Rated Amount (Rs. Crore)	PTC Series A1 Initial rating	PTC Series A2 Rated Amount (Rs. Crore)	PTC Series A2 Initial rating	Link to Initial Rating Rationale
Solstice Trust Series I 2017	Northern Arc Capital Limited	September 2017	101.57	[ICRA]A(SO)	6.85	[ICRA]BBB+(SO)	Link
Zenith Trust 2018	Northern Arc Capital Limited	June 2018	104.18	[ICRA]A-(SO)	2.25	[ICRA]BBB+(SO)	Link
Apogee Trust 2018	Northern Arc Capital Limited	December 2018	45.98	[ICRA]A(SO)	-	-	Link
CLO Hamise 01 2019	Vivriti Capital Private Limited	December 2019	15.86	[ICRA]A(SO)	1.05	[ICRA]BBB+(SO)	Link
Vivriti Bellerin 12 2019	Hinduja Leyland Finance Limited	January 2020	149.94	[ICRA]AA-(SO)	-	-	Link
Vivriti CLO 03 21	Vivriti Capital Private Limited	May 2021	27.21	[ICRA]A-(SO)	0.98	[ICRA]BBB+(SO)	Link



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