



## **Criteria for Rating of Securitised Transactions**

# Business loan

### **Primer on Securitisation (Note: Have used UK English through-out)**

Securitisation of assets entails the originator transferring the loan/asset to a bankruptcy remote Special Purpose Vehicle (SPV) or Special Purpose Entity (SPE). The SPV would raise funds from investors by issuing Pass-Through Certificates (PTCs) on the strength of the underlying receivables and further credit enhancements extended by the originator. The payments to the investor are made from the cash flows generated by these receivables owned by the SPV. Securitisation of assets is popular primarily for transactions in which the underlying assets comprise residential and commercial mortgages, vehicle financing, gold loans, LAP (Loan Against Property), construction equipment loans, personal loans, among others. Securitisation transactions essentially involve a transfer of credit risk from the originator to the investor of the PTCs by repackaging of credit risk into various classes of tradeable securities with pre-defined risk profiles.

Securitisation transaction volumes saw a significant spurt around FY19 following the failure of few large NBFCs around that period. Post these major credit events, the banks became increasingly selective in lending to the NBFC segment. The NBFCs on the other hand, were also exploring various other options to diversify their funding base. This led to many NBFCs tapping the securitisation market for the first time. The banks were also more comfortable buying a pool of retail receivables from an NBFC rather than taking a balance sheet-based exposure to the NBFC. The securitisation route was a tool for the NBFCs to manage their liquidity, asset liability mismatches and capital requirements. From the bank's perspective, it was an expedient way to increase their exposures to various retail segments – both in the PSL (Priority Sector Lending) and Non PSL category. As per Industry estimates, the securitisation volumes in FY19 were at ~ Rs.1.9 trn. Subsequently, the volumes moderated in FY21 largely due to the pandemic impact. Securitisation transactions have again picked up in FY22 at ~ Rs.1.5 trn (industry estimates). It is pertinent to note that the securitisation volumes include PTC structures as well as bilateral transactions between the buyer/investor and the seller (Originator), which are very common. Such sell-down transactions are called Direct Assignment transactions wherein the underlying assets are directly assigned to the investor, with no need of an SPV.

RBI has been regulating this segment through guidelines for Securitisation transactions from time to time. The latest RBI Directions on September 24, 2021, i.e., Reserve Bank of India (Transfer of Loan Exposures) Directions 2021 & Reserve Bank of India (Securitisation of Standard Assets) Directions 2021 lay down a framework governing these transactions.

### **Analytical Framework of Acuité**

This section covers Acuité's approach to rating Asset-Backed Securities (ABS) and Mortgage-Backed Securities (MBS), which cover the major two type of securitisation structures. In order to understand the risks associated with a securitisation transaction, it is important to first familiarise oneself with the nature of such a transaction.

Key Steps in Securitisation	Risk Associated/ Factors Analysed
From its overall portfolio, the originator demarcates a pool of assets (loans) that it wishes to securitise.	Overall Portfolio Risk
The buyer identifies and cherry picks a pool of receivables based on specific parameters such as minimum seasoning, overdue status, minimum credit score, geographical diversity, etc. The intent is to ensure that the possible delinquencies are minimised, and credit risk is effectively mitigated.	Credit Risk
The originator then sells this underlying asset pool to a separate SPV (Trust managed by a Trustee). This sale is typically made while ensuring that all risks and rewards associated with the particular asset are transferred to the SPV, thus delineating the performance of the asset pool from the changes in the credit profile of the originator.	Legal Risk
The SPV raises funds from investors by issuing them Pass-through Certificates (PTC). These funds are, in turn, paid to the originator as consideration for the sale of assets to SPV	Transaction Structure
The servicer is then responsible for ensuring the timely collection of receivables and depositing the same in a designated Trust and Retention Account (TRA). In several securitisation transactions, the originator can also act as a servicer.	Servicer Risk
The originator may provide additional credit enhancements to cover any shortfall in collections from the underlying pool and ensure that payments to the investor are in full and in a timely manner.	

Acuité evaluates individual risk elements acting at each stage of the securitisation transaction and the interplay among them.

### Acuité's Approach

## Step 1

Acuité believes that it is extremely important to understand and assess the credit policies and various underwriting practices and policies followed by the originator both at pre-sanction & post-disbursement stages. Acuité analyses the robustness and soundness of the policies adopted by the originator for the entire gamut of lending activities, including lead generation, underwriting and credit policies, post-disbursal monitoring of assets, collection efficiency and recovery / write-off policies. Acuité seeks data on various aspects of the portfolio which are called Portfolio Cuts based on parameters like such as geographical diversity, borrower profile (occupation wise), interest rate wise classification, seasoning, original maturity, LTV at origination, credit score wise classification, etc. The attempt is to understand the characteristics of the portfolio. In the case of an originator with presence across different asset classes, the delinquency patterns of each asset to class will vary. In such cases, Acuité will seek granular historical data on each asset class to assess the overall risk profile.

## Step 2

Acuité analyses the characteristics of the originator's overall portfolio as well as the relevant product's portfolio to understand delinquency risk, prepayment risk and collection efficiency. Acuité may usually rely on static pool analysis or Dynamic Portfolio Analysis to understand the delinquency patterns over a period of time. Under Static Pool analysis, all loans originated during a given period are examined for their performance across a cycle. Generally, the larger the static pool sample, the sharper will be insights regarding delinquency patterns. Similarly, several static pools are taken into consideration so as to compare their performance during multiple time periods. Acuité may also include past securitised pools in its static pool analysis. Acuité analyses the delinquency curve for each static pool to understand delinquency trends with reference to seasoning of loans as well as to compare delinquency risks that may have originated during different time periods. The analysis of prepayment curves, recovery curves and collection efficiency for various static pools provides an insight into the potential delinquencies.

In the absence of static pool data, Acuité may examine the portfolio on a dynamic basis, wherein the delinquency patterns are observed over a period of time with the underlying portfolio undergoing a change due to closures of existing loans and additions of new loans.

## Step 3

The pool being assigned is then examined for the various parameters and these pool parameters are compared with the overall portfolio parameters of the same asset class. This is essential to understand the extent of qualitative difference between the pool and the overall portfolio. The rating assigned to the PTC is based on the risk profile of the pool, industry risks, vintage risks, and other factors such as the extent of credit enhancement available. Besides analysing the pool characteristics and pool

cash flows, the rating process also looks at the structure type, waterfall mechanism and extent of credit enhancement available.

## **Transaction structure**

Acuite also analyses the transaction structure to determine the inherent protection to PTC investors:

### **A. PAR v/s Premium Structure**

Transactions wherein investors pay the outstanding principal of the underlying asset as a consideration towards the issue of the PTC are called PAR structure, i.e., PTCs are said to be issued at PAR. In this structure, typically, the yield from the underlying asset pool is higher than the yield payable to PTC holders. Thus, there will be excess interest spread (EIS) accumulated from cash flows generated by the underlying pool. This EIS would be wholly or partly available to meet any shortfall in funds generated from the underlying assets, thus providing an internal credit enhancement.

In Premium structures, on the other hand, investors pay a premium over and above the outstanding principal of the underlying asset pool. Here, the cash flows generated by the underlying pool go to PTC investors and thus, no internal credit enhancement by way of EIS is available for investors.

Besides the above structures, in certain cases, the TIUP structure (Timely Interest Ultimate Principal) is followed, which provides a flexibility of payouts to the PTC investors. Hence, in the event of intermittent shortfalls from the pool collections, the payouts to the investors are not significantly affected. Additionally, the feature of fast amortisation (Turbo-amortisation) can also be present in TIUP structures. In another form of structure, TITP (Timely Interest Timely Principal), the timely payment of PTC interest/ principal obligations is involved.

### **B. Waterfall Mechanism and Tranching**

A well-defined, legally enforceable waterfall mechanism involves slicing the entire PTC issuances into various layers or tranches, with one typically being senior and one or more subordinated tranches. The objective here is to relatively insulate the senior tranche from the delinquency and prepayment risks in the pool. Here, the first right of cash flows generated by the pool is with senior tranche investors, with residual funds flowing to subordinated tranches.

### **C. Credit enhancements (Internal as well as External)**

Generally, any securitisation transaction (i.e., PTC transaction) will have various layers of credit enhancement which support the notched-up ratings assigned to these structures as they provide additional comfort to the investors. These credit enhancements could be internal as well as external credit enhancement.

The major forms of Internal Credit Enhancements are EIS (Excess Interest Spread), OC

(Overcollateralisation) and Junior/ Subordinate tranches. Excess Interest Spread refers to the difference between the pool interest payouts received by the originators and the interest payouts made to the PTC investors. Overcollateralisation refers to the additional pool receivables made available to the investors over and above the pool principal. Junior or Subordinate tranching refers to the tranche which bears the initial shortfalls in payouts (if any) as per the waterfall mechanism laid out & the claims of the investors in this tranche will be junior or subordinate to the Senior PTC holders.

In addition to the above, the originator may also furnish additional Cash collateral, mostly in the form of fixed deposits with an established bank, on which the lien of the PTC trustee is marked. The trustee can dip into this collateral in case the payouts from the pool are inadequate to meet the payouts to the PTC investors. The extent of cash collateral to be provided will be based on various factors like pool quality, internal credit enhancement available etc. In certain cases, a corporate guarantee may be offered from a third party in place of a cash collateral. Acuité analyses the extent and quality of such external enhancement and its legal enforceability. Acuité may also analyse the legal structure to check the bankruptcy remoteness of the PTC transaction. To be considered as an effective credit enhancement, Acuité believes that these enhancements should provide the required funds before due date so that payments too are made to investors on or before due dates.

#### **Step 4**

Acuité shall initially assign a Provisional Rating based on the pool data and inputs furnished by the client based on the above steps. The Conversion of Provisional to Final rating will be subject to fulfilment of certain documentation formalities as stipulated by Acuité.

#### **Step 5**

The outstanding ratings are subject to periodic surveillance on the pool performance based on feedback and inputs received from the trustee and client.

### **KEY RISKS**

#### **A. Delinquency Risk/ Credit Risk**

The understanding of credit/ counterparty risk is critical to the securitisation transactions. Since the PTCs are issued on the strength of the underlying receivables, any weakness in performance of the underlying receivables will affect the cash flow profiles and returns of the PTC investors. Hence arriving at an estimate, the estimate of potential delinquencies in the pool is a critical point of the exercise.

Acuité examines the trends in historical delinquency rates across various periods to understand the overall asset class performance. The portfolio outstandings are categorised across time buckets such as 'On Time payment', '30+ DPD', '60+ DPD', till

'180+DPD'. Higher the 'on time' portfolio, better is the performance. While it is common to have occasional slippages from On Time to 30/60 DPD time buckets, the near-term time buckets, a higher proportion of the portfolio in longer term time buckets of 90+ DPD could indicate a structural decline in credit quality. Acuité evaluates the trend in this historical delinquency rate over a period of time. However, in cases of rapidly expanding portfolios, this delinquency ratio may understate the delinquency risk and it may be prudent to consider lagged delinquency rates as well.

It has to be understood that temporary delinquencies are to be distinguished from structural credit weaknesses. There are certain classes like Commercial Vehicle loans wherein the pool performance could indicate temporary delinquencies which eventually get rectified over a period of time. This is primarily due to uneven nature of cash inflows of the borrower and variations in fleet utilisation. The asset class and nature of security also have a bearing on the credit risk inherent in the pool. Typically, it has been observed that delinquency rates are significantly low in asset classes like housing finance vis a vis other asset classes like unsecured loans/ credit card receivables. This could be attributed to factors like nature of the asset, high proportion of owner's equity embedded in the asset and the social implications associated with such defaults. In certain other asset classes like gold loans too, the lender can immediately recover his dues by disposing of the liquid collateral. Hence the incidence of credit losses in such asset classes is relatively low.

#### B. Legal Risk

Analysis of legal risks associated with securitisation transactions is important to ensure that interest of investors is protected at times, especially when the credit quality of the originator deteriorates significantly and if the originator's lenders stake their claim on the pool receivables. Essentially, the analysis revolves around the de-linking of the underlying asset pool and credit enhancement to the pool from the credit quality of the issuer. Thus, in case the originator files for bankruptcy, the performance of the asset pool and its respective credit enhancement will remain unaffected with investors receiving their payments in a timely manner.

For this de-linking to uphold in the court of law, it is essential that the sale of assets from originator to SPV is free of any recourse and that all risks and rewards associated with the asset is transferred from the originator to the SPV i.e. the transaction satisfies the requirements of a 'true sale'. It is pertinent to note that in the event of a situation wherein the conditions of a true sale are not met and the originator faces actions from his creditors, such transactions could be derecognised and the investor's interests in such cases could be compromised. Acuité may analyse the specific terms and conditions of the asset transfer agreement, but also other documents including the rights and obligations of all involved. Acuité may also seek third-party independent legal opinion to learn about the legal risks involved in a securitisation transaction, if deemed necessary.

While assessing the legal risk of a given securitisation transaction, Acuité also takes

into account the competence and experience of the designated trustee in performing its duties and responsibilities.

#### C. Servicer Risk

Since cash flow generation from the pool of underlying assets is primarily dependent on the performance of the servicer itself, analysing the profile of the servicer becomes important. Usually in most of the cases, the originator is the servicer in most of the securitisation transactions. Since the collections are directly linked to the servicer's ability to monitor and follow-up with the borrowers, the servicer's ability to adopt and adhere to high standards of servicing, i.e. follow-up, collection, timely depositing in pay-out accounts etc. becomes critical. For medium to long tenure PTCs, the servicer's credit profile becomes critical since any sharp deterioration in the servicer's credit quality could impact its ability to discharge its obligations under the servicing agreement. Hence, in all the securitisation transactions, Acuité also analyses the financial risk profile of the servicer, the quality of its management and its track record.

Since Servicer risk is also linked to the credit profile of the originator, any deterioration in the credit quality of the originator i.e., rating downgrade, may trigger the rating of the PTCs associated with the said originator. This is essentially to assess the extent of impact of the originator's downgrade on the credit quality of the PTCs.

#### D. Commingling Risk

It has to be understood that in any securitisation transaction, there is a time lag between the periodic collections from the pool borrowers and the depositing of these collections in the escrow account of the PTC investors. The risk that the pool collections may get commingled with the originator's funds in the interim period is always present. In times of distress faced by the originator (who is the usually the servicer), it will be necessary to isolate the pool collections from the regular collections of the originator.

#### E. Macro-Economic Risk

The ability of the underlying asset pool to generate adequate, stable and timely cash flows is also influenced to a large extent by the overall economic environment prevailing in the country or the geography in which the asset class is largely concentrated. Any significant but unforeseen volatility in the macro-economic scenario can influence the value of collaterals of the underlying assets, thus influencing the credit risk associated with the pool. Income levels of the underlying borrowers and interest rates to be paid are certain key variables that impact the ability of the underlying asset pool to generate stable cash flows. Acuité factors in the expected economic conditions over the tenure of the asset pool to incorporate the likely impact of the same on the credit profile of the underlying assets.

#### F. Regulatory Risk

Any changes in the regulatory framework will have a bearing on the performance of the existing pools. For instance, a moratorium allowed by the regulator on certain

categories of loans due to instances like pandemics will affect the pool payouts, affecting their overall returns.

#### G. Interest rate Risks and Pre-Payment risks

Interest rate risks primarily arise due to a mismatch in the interest rate benchmarks for the underlying pool of assets and investors. For instance, in structures wherein loans in the pool are linked to floating rates and payouts to investors are on fixed interest rates, cash flows from the pool may be inadequate in a falling interest rate regime. While analysing the credit risk in a structure, Acuite takes into consideration the expected movement in interest rates, the cushion between cash flows being generated by the pool and payout to investors. In cases where the pool is linked to floating interest rates, movement in benchmark interest rates also impacts the expected prepayments in the pool. Prepayment risk arises when investors receive funds earlier than expected, thus exposing them to risk of re-investing these funds at lower yields. Typically, decreasing interest rates and increasing income levels lead to higher prepayments in pools based on retail loans. While analysing prepayment risk for a given transaction, Acuite analyses the expected movements in interest rates and income levels with historical prepayment patterns for a given asset class.

### RATING SCALE

As per SEBI guidelines, ratings where the credit enhancement/structure around cash flows lead to rated instrument being bankruptcy remote of the issuer/originator **will carry the 'SO' (Structured Obligation) suffix**. Acuite believes that 'SO' ratings shall be assigned to ratings of Securitisation transactions entailing ratings assigned to PTCs (Pass Through Certificates). **The following categories of structures will be eligible for SO suffix.**

Type of Instrument / Structure	Rationale
ABS	Bankruptcy remote structure
MBS	Bankruptcy remote structure
CDO	Bankruptcy remote structure
Capital protection-oriented funds	These are very similar to CDOs involving a pool of corporate debt exposures, and hence 'SO' suffix ensures consistency. The ratings would be on the regular rating scale for debt instruments and not on the mutual fund rating scale.

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