



## Covered Bonds

**B O N D**

Covered Bonds are hybrid instruments combining the characteristics of a PTC (Pass through certificates) and NCD (Non-convertible Debenture) as they provide dual recourse to the investor, i.e. recourse to (i.) cover pool assets that are held in a bankruptcy remote Special Purpose Vehicle distinct from the originator and (ii.) unlimited recourse on the Issuer. A PTC holder's returns are largely dependent on the underlying pool performance, i.e. mostly detached from the standalone credit profile of the issuer/originator. The originator's role in PTC transactions is limited to the servicing and the credit enhancement-related obligations, which are decided upfront. Hence, a covered bond partakes the traits of a PTC and a bond. Generally, in a covered bond transaction, the identified pool of receivables is transferred to a trust formed by the originator. The trust is a special-purpose vehicle, which guarantees the obligations to the bondholders. It is to be noted that, notwithstanding the fact that the underlying pool has been isolated from a legal standpoint, the transaction continues to be reflected on the books of the issuer like an NCD transaction. The difference between such a Covered Bond transaction and an NCD transaction is that, unlike a bond investor, a covered bond transaction is legally structured to ensure that the investors can access the underlying pool of assets (say receivables), especially in case of trigger credit events like sharp rating downgrades, bankruptcy, etc. One more factor favouring covered bonds is that the deals are generally over-collateralised, i.e. value of receivables transferred is higher than the issue size. From an issuer standpoint, it results in a lower cost of funds, whereas from an investor perspective, the dual recourse results in an improvement in recovery prospects.

It is to be understood that the mismatch between the maturity profiles of the underlying assets and the maturity profiles of the covered bonds makes asset liability management important. Due to factors like occurrences of defaults/ delinquencies, pre-payments and foreclosures, the collateral coverage may fluctuate, making it imperative that the collateral coverage envisaged at inception is adhered to at all times.

From a Covered Bond rating standpoint, Acuité will be guided by the following factors

- **Standalone Credit Profile of the Issuer:** As Covered Bonds are hybrid instruments combining the characteristics of NCD (Non-convertible Debenture) and a PTC (Pass-through certificates), the credit assessment of the issuer to determine its repayment capacity is the initial step of the rating process for evaluating such transactions. Thus, Acuité analyses the financial risk profile of the servicer, the quality of its management and its track record.
- **Characteristics of the Underlying Pool:** The characteristics and credit quality of the underlying pool is taken into consideration for the assessment of such transactions. Acuité evaluates the impact of several factors like characteristics of asset class, delinquency level, geographical concentration, interest risk and pre-payment risk. Accordingly, Acuité lays stress on the pre-defined pool eligibility criteria and its adherence by the issuer.
- **Extent of Credit Enhancement:** Based on the credit quality of the issuer and risk profile of the underlying pool, the issuer may employ additional credit

enhancements (external) in the form of Over Collateralisation (OC), Cash Collateral (CC), Excess Interest Spread (EIS). Acuité analyses the extent and quality of this additional support and its legal enforceability.

- **Legal Risks in the Transaction:** Analysis of legal risks associated with such transactions is important to ensure that interest of investors is protected at times, when the credit quality of the originator deteriorates significantly. 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. 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. Acuité analyses not only 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 a third-party independent legal opinion to learn about the legal risks involved in a securitisation transaction if deemed necessary.
- **Extent of mismatch between the maturity of the pool and the covered bond maturity:**  
Acuité will decide the extent of notch up over the issuer's standalone credit profile based on its assessment of the above parameters. The rating will be suffixed with (CE) to indicate that the rating is driven by the structure.

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