This methodology document stands superseded. Refer to ICRA's website www.icra.in to view the updated methodology document on this subject.

ICRA

ICRA Rating Feature

RATING METHODOLOGY

February 2021

Rating Methodology for Covered Bond Transactions

What is a Covered Bond?

In India, development of the covered bond market is in its nascent stage. In the covered bond transactions seen so far, an Issuer issues Bonds / Non-Convertible Debentures (NCDs) and simultaneously assigns a pool comprising of loan receivables (collateral / cover pool) as security to a Special Purpose Vehicle (SPV/Trust). After assignment, the cover pool becomes the exclusive property of the Trust (bankruptcy remote from the other creditors of the Issuer) and all the rights, title and interest of the Issuer in the cover pool gets transferred to the Trust. Alternatively, the assignment can happen post a trigger of certain pre-defined events wherein the cover pool shall become the exclusive property of the Trust at such subsequent date. Such subsequent assignment does not need any further action or deed from the Issuer. The SPV Trustee (on behalf of the Trust) provides a Guarantee on the covered bonds in favour of the Debenture Trustee. The Guarantee would be to meet any shortfalls in the repayment of the NCDs. The trust property - comprising of the cover pool and additional cash collateral (if any) provided by the Issuer - are offered as security for the repayment of the Debentures.

The primarily obligation of meeting the NCD payments is on the Issuer as the NCDs are on-balance sheet liability of the Issuer. Till the time Issuer is meeting the payment on the NCDs, the collections on the assigned cover pool may be released back to the Issuer. However, upon occurrence of pre-defined trigger events, the debenture trustee would invoke the Guarantee provided by the Trust and the Trust assets (collections on the assigned cover pool and the credit enhancement) would be used for meeting payments on the NCDs. The guarantee obligation of the Trust (if the guarantee gets invoked) shall rank senior to any other obligation of the Trust.

Investors of the NCDs in such a structured transaction (in general called covered bonds) have the benefit of dual recourse – unlimited recourse on the Issuer and recourse on the Trust assets (akin to a securitisation transaction) in the event the Issuer does not pay. In place of an NCD, a similar structure can be replicated for a term loan (covered loan transaction). Henceforth in this document, we would use the term ‘covered bonds’ to denote both the covered bonds as well as covered loans.

Credit enhancement in covered bonds – A Theoretical Framework

Credit ratings assigned by ICRA address timely payment of due principal and interest on the debt being rated. A single-day-single-rupee delay in payment of amounts due is treated as default. Thus, a particular debt instrument of an Issuer can be rated higher relative to its standalone credit rating if the credit enhancement associated with that debt instrument ensures that the investor in this instrument is more likely—relative to the Issuer’s other debt holders—to receive all payments in full and in a timely manner, as per the instrument’s repayment schedule.

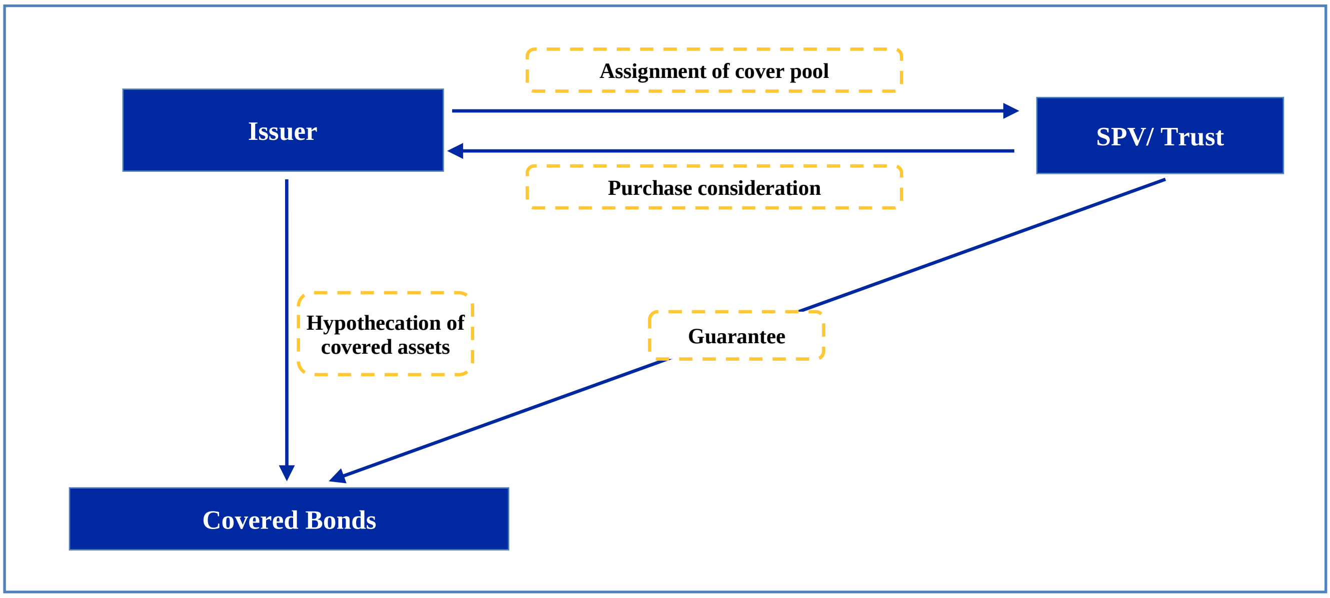
Regular debt obligations are rated basis the balance sheet strength of the Issuer. The covered bond investors have the benefit of dual recourse – unlimited recourse on the Issuer and recourse on the Trust assets (cover pool and additional cash collateral, if any) in the event the Issuer does not pay. The cover pool assets are bankruptcy remote from the Issuer. A default on such covered bonds would happen only when neither the Issuer is able to pay, nor the proceeds realised from the Trust assets are sufficient to pay the obligations.

Credit comfort related to the guarantee provided by the Trust in turn depends on the strength of the Trust assets. As long as the derived credit strength of Trust assets is better than the stand-alone rating of the Issuer, the probability of default of the instrument would be lower than the probability of default of the Issuer.

Typically, the underlying asset classes forming cover pool can be loans for financing vehicles - private vehicles like cars and two wheelers (TWL) or commercial vehicles (CV) (like trucks and buses), construction and farm equipment (CE), loans against gold, unsecured personal loans (PL)/ micro loans or small business loans, loans given for acquisition of residential property (home loans, HL) or loans against existing residential or commercial property (loan against property, LAP).

Transaction Schematic

The transaction schematic is depicted below –



ICRA's Approach for Rating Covered Bond transactions

ICRA's rating framework/ methodology for covered bond transactions involves analysis of the following key risks:

1. Legal Risk Analysis

The legitimacy of the assignment of loans to the trust from a legal standpoint is an important risk to be considered. While there are no specific laws or regulations governing covered bond transactions in India at present, ICRA relies on the legal opinion provided by the transaction counsel. Among other things, the legal opinion should opine on whether the assignment of receivables constitutes a legal sale of receivables from the Issuer to the SPV such that in the event of bankruptcy proceedings on the Issuer, other creditors would not have a claim on the receivables from the assets transferred to the SPV.

The other transaction-specific points that ICRA gathers from the legal opinion provided by the transaction counsel are –

- Whether the Assignment Documents have been executed in accordance with the prevailing stamp duty and registration laws
- Whether the assignment of receivables is valid as per the terms of the underlying debt agreements i.e. the debt agreement should not have imposed any restrictions on the assignment of receivables
- In case the assignment is effective basis any trigger events, there is no requirements or legal hurdles which may jeopardise the effectiveness and validity of the assignment
- All the documents of the transaction constitute legal, binding and enforceable obligations of all the counterparties concerned.
- The transaction is not in contravention of any prevailing Indian law.

ICRA may assign a 'Provisional' rating to covered bond transactions if the rating is contingent upon the completion of certain actions or the execution of certain documentation. The ratings are converted from ‘Provisional’ to ‘Final’ after a review of the legal opinion and the executed transaction documents to determine whether the key structural features of the transaction, as envisaged in the draft documents, are getting accurately incorporated in the final documents. For more details, please refer to ICRA's Policy on assigning provisional ratings available on ICRA’s website.

2. Assessing the credit quality of the Issuer

As covered bonds are on-balance sheet liability of the Issuer, Issuer is obligated to meet the repayment obligation. The credit rating of covered bond transaction, as a first step, would depend on the credit quality and repayment capacity of the Issuer. Hence, ICRA assesses the credit quality of the Issuer based on the relevant rating methodologies (as available on ICRA’s website) applicable for the sector in which the Issuer belongs.

3. Cover Pool Analysis

As the collections from the underlying cover pool are to be utilised (in case Issuer fails to pay or on occurrence of any other trigger event) to meet the bond payments, ICRA evaluates the credit quality of the cover pool along with the credit enhancement in the transaction. ICRA’s methodology to analyse the cover pool assets is similar to the methodology followed in securitisation transaction. For details on the same, please refer section titled ‘Collateral Risk Analysis’ covered in ICRA’s Rating Methodology for Securitisation Transactions (available on the following methodology page).

Additionally, ICRA focuses on the pool eligibility criteria defined in the transaction documents to assess whether the cover pool is of an acceptable quality, since the pool assets can change before a trigger event occurs unlike a securitisation transaction where the pool is typically static. Such a change in the cover pool would happen due to prepayments in the pool (whereas no similar prepayments would happen on the bond) or a lower tenure of the initial pool which would lead to quicker amortisation of the pool as compared to the bond. In order to maintain the defined asset cover for the transaction, Issuer would have to assign additional contracts as per the eligibility criteria to the cover pool on a recurring basis. ICRA incorporates the implication of such possible changes in pool assets while analysing the cover pool.

4. Structure Risk Analysis – Modelling the cash flows

The final step in rating covered bond transaction is an evaluation of the credit enhancement by modelling the projected cash inflows from the cover assets and its ability to timely service the debt payments, in case Issuer fails to meet its obligation on the bonds. The uncertainty in the quantum and timing of the actual cash inflows from the cover assets arises out of the possibility of delinquencies, losses as well as prepayments in the pool. On the other hand, the quantum and timing of debt payments is driven by the terms of the transaction, including the repayment schedule, waterfall mechanism, incidence of expenses, and the credit enhancement mechanism.

For modelling the inflows (‘the asset side’), ICRA attempts to factor the various possible scenarios of pool collections through a simulation exercise. For modelling the outflows (‘the liability side’), the simulated collections are allocated as per the ‘cashflow waterfall’ stipulated in the transaction documents. The objective of cashflow modelling is to assess the adequacy of the credit enhancement that would be required for achieving a particular rating. Thus, through a simulation exercise, varying levels of credit enhancement are tried out to assess the adequate level of credit enhancement such that the default probability/expected loss of the instrument being rated is commensurate with the benchmark level of the proposed rating.

The key variables for the simulation are losses and prepayments. The key inputs, viz., mean and standard deviation are calibrated based on the collateral analysis as described ICRA’s Rating Methodology for Securitisation Transactions. In a diversified retail loan pool, all the underlying loans are not expected to default simultaneously. Indeed, certain loans may pay for a certain period and default later. Thus, another input into the model is the timing of the losses, i.e., the period over which the losses happen or the loss build-up and recovery thereafter. ICRA’s assumption on the loss build-up typically depends on the nature of the asset class and historically observed trends.

The cash flows are further modified for the expected prepayment rate and the pace of prepayment at different points. Prepayments can also have an impact on credit enhancement utilisation.

Modelling Approach

The scheduled repayments to the investors are calculated by ICRA based on the pool cashflows, the structure of the transaction and the payment priority (i.e. waterfall mechanism). The credit enhancement available in the transaction is also factored in. ICRA's cash flow modelling for rating covered bond transactions involves simulation of potential losses, delinquencies and prepayments in the pool. In each scenario the pool collections so simulated are allocated as per the 'cashflow waterfall' stipulated in the transaction documents. The losses and prepayments are assumed to follow a log-normal distribution. The mean and the Co-efficient of Variation (CoV) are calibrated on the basis of observation from the performance of the Issuer's portfolio, past rated ICRA pools, assessment of the current pool as well as possible changes in the pool (and its characteristics) during the tenure of the bonds. ICRA's estimate of the variability of losses also considers the track record of Issuer and the obligor concentration in the pool. ICRA also factors in the possible variability of interest rate on the cover pool and/or cover bonds, while assessing the credit enhancement.

In all simulated scenarios, the incidences of default to the investor as well as the extent of loss to the investor in the event of default are measured. These are then compared with ICRA's internal benchmarks for the proposed rating.

5. Other factors considered in the rating process are given below:

- *Guarantee from Trust to be unconditional and irrevocable*– The guarantee must be unconditional and irrevocable. The guarantee obligation of the Trust shall rank senior to any beneficial payments by the Trust to the Issuer.

- *Other debt of Issuer and acceleration on cross default* – Rating for covered bonds can be constrained if either the Issuer has other debt on its balance sheet or incremental debt is envisaged in future and the covered bonds have an acceleration clause owing to cross default by the Issuer on its other debt.

  In case of presence of cross-default clauses, any default on other debt (rated lower than the rating of covered bonds) would trigger an acceleration of the covered bonds, leading to higher likelihood of default on the latter (as the collection from pool assets would only be realised over a longer period of time). Thus, the probability of default of covered bonds may not be materially different from the probability of default of the other debt.

- *Guarantee invocation and payment mechanism* – The invocation of the Trust guarantee and subsequent transfer of the collections from the Trust assets by the Trust should happen in a timely manner. In these structures, the Issuer has to fund a designated account prior to the due date of payment to the investors. The lender or the Debenture Trustee checks the adequacy of funds and invokes the guarantee in the event of any shortfall. The Trust (as a guarantor) is obligated to fund the designated account prior to the due date to ensure timely payment to the investors on the due date.

- *Forms of credit support as part of Trust assets -* The scheduled cash inflows from the cover pool may be affected due to delays in repayments or prepayments, and payments to the investor may potentially vary. To protect the investors from shortfalls owing to delay or defaults in the pool, credit enhancement is generally part of the cover assets. The credit enhancement may be in-built in the structure (Excess Interest Spread or Over-Collateralisation) or may be provided through an external source (cash collateral).

6. Counterparty Risk Analysis

There are various counterparties to a transaction – the Servicer and Issuer (both typically being the same in the Indian context – the Issuer acts as a Servicer for servicing the assigned pool), debenture trustee, SPV trustee, cash collateral provider, guarantee/undertaking provider, and account bank. ICRA analyses the risk posed by each of these counterparties in a transaction and factors the risk into the final ratings assigned.

Servicer

Typically, the Issuer acts as a Servicer for servicing the assigned pool and is responsible for the collections from the cover pool. The servicer risk also carries a commingling risk since there could be a lag between receiving the collections from the pool of borrowers and depositing the funds to the Trust account. The risk principally arises during the period the pool cash flows merge with the cash flows of the servicer. If the servicer was to go bankrupt during this time, there is a chance that the pool cash flows could potentially be treated as part of the bankrupt servicer's estate. Any legal proceedings would also result in a delay in the investor payouts. Upon a rating downgrade, the transaction documents could provide for a back-up servicer or more frequent transfers of the pool cash flows from the servicer's account to the Trust Account.

Trustee

A trustee or the investor's representative is a very crucial counterparty to the entire transaction. In covered bond transactions, there are two different trustees – Debenture Trustee and the SPV Trustee. Debenture Trustee is appointed under the Debenture Trust Deed and is responsible for debt servicing related matters for the benefit of NCD investors. SPV Trustee is responsible for managing the Trust assets. In case Trust guarantee is invoked by the Debenture Trustee, the SPV Trustee is obligated to pass on collections from the cover pool and other Trust assets to meet any shortfall on the dues to the NCD investors.

In the event any of the trustees being unable to carry on their roles properly, then the transaction documents typically provide an option to replace the trustee with the investors'. approval. Since the Trustee can be easily replaced, the counterparty risk associated with the Trustee is assumed to be low.

Cash Collateral Provider

The cash collateral provider is typically the Issuer in covered bond transactions; however, the cash collateral can also be provided by a third party. The cash collateral should ideally be in the name of the SPV trustee or assigned to the Trust. However, in most transactions, the cash collateral is typically held with an account bank in the name of the Issuer with a lien marked to the SPV trustee.

Guarantee Provider

Certain transactions may also have credit enhancement in the form of a guarantee from a third-party (rated higher than the Issuer). In such cases, the rating of the guarantor would also become relevant.

Account Bank

The Collection & Payout Account (C&P Account) is an account wherein the collections from the borrowers are deposited by the servicer and the payment is made to the investors, post the trigger event. Also, the cash collateral for securitisation transactions is held with an account bank. Therefore, the bank with which the C&P Account and the cash collateral is maintained, is an important counterparty and must be adequately rated (for example, in transactions where covered bonds are rated at AAA level, the Account Bank must be rated at least AA-). At times, the transaction documents provide for replacement of the bank if the ratings are downgraded below the threshold level.

Summing Up

The approach used by ICRA to evaluate the credit rating of the covered bond transactions incorporates the assessment of the credit risk of the Issuer, assessment of the credit enhancement achieved from the cover pool assets by modelling the projected cash inflows and debt repayments with statistical techniques to assess the adequacy of the credit enhancement under the structure for the specific rating level. The various assumptions made while modelling the default probability / expected losses to the NCDs being rated may change from time to time based on the specific structure of a transaction and the credit quality of the cover pool and Issuer.

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